CAR REFORM:
SHAPING THE RESIDUAL MARKET FOR THE 1990's

A Report Prepared in Accordance with
Section 66 of Chapter 273 of the Acts of 1988

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Commissioner of Insurance
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EXECUTIVE SUMMARY

As we enter the final months of the 1980's, we see an automobile insurance market in Massachusetts that has been in crisis, or faced serious problems, for much of the last decade. We are also at a time of strong, positive change -- change that promises more stability, more responsiveness to consumers, more effective ways of dealing with the unacceptably high costs of automobile accidents in our state. Last November, the Legislature took a major step by enacting Chapter 273 of the Acts of 1988 ("Chapter 273" or "the 1988 Reform Law"). This law updated our no-fault system, lowered the costs of repairing damaged cars, expanded consumers' choices and initiated long-term, cost-saving efforts that will benefit consumers into the 1990's.

Chapter 273 also required the Commissioner of Insurance to develop and propose reforms to the residual market in Massachusetts -- the pool of risks that insurers are not willing to write voluntarily -- which is currently administered by Commonwealth Automobile Reinsurers ("CAR"). CAR is the legislatively created entity which guarantees the availability of basic automobile insurance coverage to all drivers in the Commonwealth. This report contains my proposals to revise the structure and operations of CAR.

These proposals seek to make the residual market more responsive and fairer, while reducing its size over the next four years to half its 1989 market share, as well as reduce half its current deficit. Ultimately, reducing CAR's size has the potential for saving consumers hundreds of millions of dollars in the 1990's.

A. The Process

The report is the product of a process that began shortly after the passage of Chapter 273. That process included two formal public hearings by the Division, along with numerous meetings by committees of CAR and by the Commissioner and Division of Insurance ("the Division") staff with CAR and other industry representatives, with the Attorney General, with legislators and with representatives of consumer groups. The Division received detailed recommendations from the Attorney General, CAR and the American Insurance Association ("AIA") which are attached to this report as appendices, together with the report of the actuarial and consulting firm of Tillinghast, which was engaged by the Division and CAR, at CAR's expense, to provide actuarial and other technical analysis to assist in the development of our conclusions and proposals. The recommendations from numerous other participants were also of immense help.

The consultation process described above and required by Section 66 was invaluable in arriving at the conclusions in this report. Because of sometimes diametrically conflicting economic

interests, consensus was never a realistic expectation, and this is not a consensus report. The conclusions and final proposals undoubtedly will not please some of the participants. However, while the conclusions I have reached may not be unanimously supported, they are what I firmly believe to be fair to all participants and good for consumers and the market in general. If the integrity of the package is maintained, the proposals will not seriously disadvantage or advantage any particular interest or group, but they will offer the realistic possibility of stabilizing a market that has rapidly been approaching alarming disarray.

B. The Residual Market

Under our system of rate regulation some risks, particularly inexperienced and urban drivers, are not priced at a level which will generate a profit after payment of their claims. Thus, insurers would not ordinarily choose to write those risks. To avoid having any segment of the population denied coverage, insurers have therefore been compelled to issue coverage involuntarily. In an effort to make that process fair, all insurers are required to share in underwriting the losses of that involuntary "residual" market, through CAR.

Every insurer which writes motor vehicle coverage in the Commonwealth is required to be a member of CAR. CAR is governed by a Governing Committee representing insurance companies and producers (brokers and agents), appointed by and subject to general supervision by the Commissioner. CAR writes insurance

through approximately 20 companies called servicing carriers, representing 90 percent of the total automobile insurance market. When an applicant for insurance goes to a broker/agent or major direct writing company, the application can be accepted by the agent's insurer (or the direct writer) as voluntary business or the applicant can be insured through CAR. The option is up to the insurer. The applicant will not know whether his or her policy has been insured through CAR, and companies and brokers/agents are required to treat those consumers whose policies are ceded to CAR the same as consumers whose policies are voluntarily written by companies.

Under the CAR Plan and Rules of Operation, all of the CAR business is pooled, and after the close of the year, CAR losses are totalled and generally distributed among all of the insurers on the basis of their adjusted share of the voluntary market. Insurers are given credits for their own expenses and for brokerage commissions, as well as additional credits for servicing certain less desirable markets. These credits can make some types of CAR business attractive to the more efficient servicing carriers.

Every licensed broker and agent writing automobile insurance in the Commonwealth is entitled to be assigned to a servicing carrier, except in cases of agent fraud, license revocation, breach of contract or default in the payment of premiums. When an agent/broker has no company willing to do automobile business with him voluntarily, the broker can write only through his or her CAR

servicing carrier. Such brokers are called "exclusive representative producers" ("ERPs"). There are currently 1,675 active exclusive representative producers in the Commonwealth.

CAR now insures approximately 70 percent of the private passenger market, a higher market share than any other state's residual mechanism. The CAR deficit for the 1988 fiscal year is estimated to be $534 million. That deficit is spread over every automobile insurance policy in the state.

C. The State of the Automobile Insurance Market

For the last several years, Massachusetts has faced a continuing crisis in the private passenger automobile insurance market. Consumers felt the pinch in the original 1987 and 1988 rate decisions, yet companies challenged those rates in court and won additional increases. Company withdrawals from Massachusetts over the last three years have caused severe market stresses, and there have been numerous challenges to the CAR rule governing the allocation of losses among the companies ("Rule 11").

If another large segment of the market withdraws, the alternatives for consumers, for the industry and for public officials may be very unattractive, such as the consideration of a state fund for automobile insurance, which I believe no responsible person sees as a workable or desirable approach. We must take steps now to prevent that kind of result, steps that many will find difficult, but which I believe are in the best interests of the entire market.

The successful 1988 Reform Law and initiating the process of reforming CAR have generated encouraging signs that stability is returning to the market, and I believe that with further efforts in the coming months the situation can be changed to bring stability to Massachusetts consumers.

D. Tillinghast Analysis

The findings and conclusions of the Tillinghast analysis of the Massachusetts private passenger automobile insurance market and the Division's proposals to change the structure and operations of CAR are summarized in Section II of the report. (The full Tillinghast report is attached as Appendix A.) Based on the Tillinghast assumptions and projections, which do not account for any change in insurers' CAR strategies in response to these proposals, the Division's CAR reform package can be expected to reduce the CAR deficit significantly. By simply changing the CAR rules, without any change in insurance company behavior, for policy year 1993 alone the CAR deficit is projected to be $100 million less than under the current system# [This figure is derived by using the Commissioner's rate decision loss ratio assumption developed by Tillinghast rather than the alternative, higher loss ratio also used by Tillinghast. If the higher loss ratio is used, the deficit savings for 1993 would be less.], and the remaining deficit will be spread over twice as many voluntary policies, thereby greatly reducing the CAR burden on the market. However, assuming that insurance companies are motivated to increase their profits or returns, and will therefore respond to

the strong economic incentives contained in this report, the proposals will reduce the CAR deficit far beyond the Tillinghast model's necessarily simplified projections.

E. Conclusions and Proposals

Section VI contains my findings, conclusions and recommendations. There are seven major parts to this reform. They are as follows:

1. Revise the structure and governance of CAR

Currently, there are thirteen members of the CAR Governing Committee, who are appointed by the Commissioner to staggered six year terms. All of the current members represent either insurers or agents/brokers. I propose to have consumers represented on the Governing Committee by adding two public members, who will be people with expertise relevant to the Massachusetts automobile insurance system. To increase the responsiveness of the Governing Committee, I propose shortening the terms of the members of the Governing Committee from six years to four years. This will also provide the potential for more industry representatives to serve on the Governing Committee. I also propose to adopt standards to be considered by the Commissioner in making appointments which will encourage broad representation on the Governing Committee of as many divergent interests within the industry as possible.

2. Impose mandatory cession limits for 1990 and cession targets for ensuing years.

The CAR Governing Committee voted to recommend a mandatory cession limit of 55 percent of private passenger voluntary business for 1990, followed by non-mandatory goals in later

years. Under the current, uncertain market conditions, a mandatory limit for the first year is both appropriate and necessary, particularly in light of the fact that the formula replacing Rule 11 will begin taking effect in January 1990. For years after 1990, I am proposing targets, with consideration of further limits deferred unless those targets are not met. Other proposals create strong economic incentives for depopulation, and are likely to be more effective than absolute caps.

3. Expand credits for writing voluntary business

CAR proposed, and the AIA endorsed, additional credits against a company's share of the CAR deficit to provide an additional incentive for companies to write business voluntarily. Current CAR Rule 12 provides such credits for business in certain high rated territories, but current Rule 11 has, in some instances, acted contrary to that incentive and greatly, though inadvertently, blunted its effectiveness. The proposal would expand the credit system to include driver classifications, in addition to territorial ones, which can be used to identify policies which insurers now have an incentive to cede to CAR because they appear actuarially to be underpriced, such as inexperienced male drivers. These new credits will have no adverse impact on consumers, will greatly speed depopulation of CAR and reduce the CAR deficit.

4. Phase out current CAR Rule 11

The current CAR rule governing the allocation of the CAR deficit among the companies has acted both to stabilize the market

by discouraging company withdrawals and, in contrast, inadvertently to destabilize it by encouraging the growth of CAR. It has been the source of enormous controversy and litigation. Rule 11 has also been cited as a principal factor, together with real or perceived rate inadequacy, causing eight companies to withdraw from the Massachusetts automobile insurance market in the last three years.

Rule 11 in its original and current form has served a valuable purpose. However, changing market conditions dictate that it be changed in a way that will help to depopulate CAR while still enhancing market stability. Accordingly, current Rule 11 should be phased out gradually beginning in January 1990, to be replaced by a "utilization" formula which will be fully in place by January 1993. The utilization formula gives companies an incentive to keep business on their voluntary books instead of ceding it to CAR. However, at least during the transition, it is important to retain the market stabilization features of current Rule 11 which have discouraged company withdrawals.

5. <u>Require All Companies to be Servicing Carriers</u>

I propose that all companies become servicing carriers with the option of either buying out of the servicing carrier obligation or contracting with another carrier to provide the services. There are benefits to consumers and to the system of having each company be a servicing carrier. Consumers will have more freedom of choice of companies, the deficit allocation formula will be simpler and any transition to competition could be more easily accomplished.

6. <u>Restrict the growth of ERPs</u>

ERPs are agents/brokers who were guaranteed appointment to at least one company to ensure the availability of coverage and service in all areas of the state, particularly in those urban territories where most companies do not want to write business voluntarily. Unfortunately, there has been a large increase in both the number of ERPs and the volume of their business in the last several years, much of ERP business has developed in areas previously served by voluntary agents, and virtually all of that business is insured through CAR.

In making ERP appointments, there should be a "market need" assessment to ensure that the original purposes in creating the ERP category are being fulfilled. Current ERPs whose offices are located in areas where there is no market need will have to demonstrate to an appropriate CAR committee that they have been unable to obtain a voluntary contract. If the CAR committee finds that an ERP who is not in a "market need" area, 1) has been offered and refused a voluntary contract with a company; or 2) has not made a substantial effort to obtain a voluntary contract, that ERP will receive a lower commission structure for three years. If the ERP fails to make arrangements with a company on a voluntary basis by the end of the three years, the ERP will lose his/her ERP status. In addition, to improve ERP service there should be new standards for ERPs as proposed by CAR, including training and educational requirements for new ERPs to ensure they are completely versed in the highly technical and specialized field that automobile insurance has become.

7. <u>Revise the expense allowance formula for reimbursing servicing carriers</u>

I am also adopting CAR's proposal to revise the method for reimbursing the companies for their expenses in servicing CAR business. The current expense allowance has discouraged companies from taking potentially profitable business out of CAR, and has possibly undercompensated companies with the worst CAR business (in terms of losses). The expense allowance will be adjusted downward for CAR policies with a low claims frequency, and adjusted upward for high claims business. That will reverse the current incentive to keep good risks in CAR.

The current problems with automobile insurance and CAR present us with a unique opportunity, one that may not occur again. The Massachusetts automobile insurance market has gone through crises that have recurred regularly over at least the last fifteen or twenty years, heating up approximately every five years, with greater or lesser intensity depending on the financial conditions of the companies nationally, the perception of rate adequacy and other factors. During the last two years, there have been the initial signs that the market is beginning to stabilize. In recent weeks, we had one of the most positive signs of all -- a company group which had already announced its decision to withdraw from Massachusetts formally reconsidered its decision and has agreed to stay at least through June 1990 to have sufficient time to assess the impact of various positive changes we are making, including those contained in this report. There is much to be done in the coming months to ensure a smooth implementation of the

package I am proposing, but it is a major step toward giving us the changes we need for the kind of automobile insurance market consumers will demand in the 1990's.

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I. INTRODUCTION

As we enter the final months of the 1980's, we have an automobile insurance market in Massachusetts that has been in crisis for much of the last decade. We are also at a time of strong, positive change -- change that promises more stability, more responsiveness to consumers and more effective ways of dealing with the unacceptably high costs of automobile accidents in our state. Last November, the Legislature took a major step by enacting Chapter 273 of the Acts of 1988 ("Chapter 273" or "the 1988 Reform Law"). This law updated our no-fault system, lowered the costs of repairing damaged cars, expanded consumers' choices and initiated long-term, cost-saving efforts that will benefit consumers into the 1990's.

A. Section 66

Chapter 273, in mandating significant reforms to the automobile insurance system, recognized that meaningful reform had to address the size of the residual market and its deficit. The "residual market" is the pool of insurance risks that insurance companies ordinarily do not write voluntarily. In 1988, approximately 64 percent of the automobile insurance policies were insured through the residual market and the deficit in that market after payment of claims and expenses was

estimated to be $534 million. For 1989, the residual market share has increased to nearly 70 percent. This percentage goes far beyond anyone's reasonable estimate of the numbers of "bad" risks that probably should be in the residual market. Furthermore, over 80 percent of the claims in Massachusetts are attributable to the policies insured in the residual market.

Chapter 273 included a directive to the Commissioner of Insurance ("the Commissioner") to develop revisions to Commonwealth Automobile Reinsurers ("CAR"), the current automobile insurance residual market mechanism. Section 66 of Chapter 273 ("Section 66") mandates that the revisions to CAR: 1) provide for a fair and equitable formula for allocating the CAR losses, risks, premiums and expenses; 2) have the effect of decreasing the number of policies ceded to CAR; and 3) enhance cost containment by member companies.

Section 66 suggests some possible revisions which might accomplish those legislative goals: specific cession limitations; criteria regulating the conditions under which policies may be ceded; specific limitations upon the percentage of any individual risk which may be reinsured; provisions for the removal of policies from the plan based upon excellent driving records; cession penalties or charges to reflect the cost of the plan's cost-containment and anti-fraud programs; changes to the administration and finance of the plan; and a provision which requires all companies to participate as servicing carriers.

Section 66 gives the Commissioner broad discretion to adopt some, none or all of the suggested revisions or to develop different revisions to accomplish the legislative objectives, with or without need for further legislative action.

This report contains my proposal for implementing Section 66. As will be described in more detail below, this strategy was developed after consulting with CAR, the Attorney General, consumer representatives, the industry, agents' associations and other interested parties.

This proposal seeks to make the residual market more responsive and fairer, while reducing its size over the next four years to half its 1989 market share, and half its current deficit. Ultimately reducing CAR's size has the potential for saving consumers hundreds of millions of dollars in the 1990's.

B. <u>Commonwealth Automobile Reinsurers ("CAR")</u>

Under our system of rate regulation, some risks, particularly inexperienced and urban drivers, are not priced at a level which will generate a profit after payment of their claims. Thus, insurers would not ordinarily choose to write those risks. To avoid having any segments of the population denied coverage, insurers have been compelled to issue coverage involuntarily. In an effort to make that process fair, all insurers are required to share in the losses of that involuntary "residual" market through CAR.

Every insurer which writes motor vehicle insurance coverage in the Commonwealth is required to be a member of CAR. CAR is

governed by a Governing Committee representing insurers and insurance producers (brokers and agents), appointed by and subject to general supervision by the Commissioner. CAR writes insurance through approximately twenty companies called servicing carriers, representing 90 percent of the total automobile insurance market. When an applicant for insurance goes to a broker/agent or direct writing company, the application can be accepted by the agent's insurer (or the direct writer) as voluntary business, or the applicant can be insured through CAR. The option is up to the insurer. The applicant does not know whether his or her policy has been insured through CAR, and companies and producers are required to treat consumers whose policies are ceded to CAR the same as consumers whose policies are voluntarily written by companies. There is no price difference between a voluntary and a ceded policy.

Under the CAR Plan of Operation and Rules, all the CAR business is pooled, and after the close of the year, CAR losses are totalled and distributed among all the insurers on the basis of their adjusted share of the voluntary market. Insurers are given credits for their own expenses and for brokerage commissions, as well as additional credits for servicing certain less desirable markets. These credits can make some types of CAR business attractive to the more efficient servicing carriers. The CAR deficit is spread over every auto insurance policy in the state, and is intended to be made up by profit margins on voluntary policies.

Every licensed broker and agent selling automobile insurance in the Commonwealth is entitled to be assigned to a servicing carrier, except in cases of agent fraud, license revocation, breach of contract or default in the payment of premiums. When producers have no company willing to do auto business with them voluntarily, they can write only through their CAR servicing carrier. Such producers are called exclusive representative producers ("ERPs").

C. Causes of the Growth of the Residual Market

1. Rate Adequacy

Rate adequacy and the companies' perception of rate adequacy have a direct and significant impact on the number of policies ceded to CAR and on the CAR deficit. When rates are adequate, due to the class and territorial subsidies built into the rates, companies may still choose not to write certain risks voluntarily because those risks are not likely to be profitable. These would generally be high-risk drivers or classes and they probably constitute no more than one-third of the market.

However, when rates are not adequate or are perceived to be inadequate, companies determine that an even greater number of risks are not likely to be profitable and companies choose to cede those risks as well. The greater the rate inadequacy or perception of rate inadequacy, the greater the number of risks that companies may rationally determine are not likely to be profitable and therefore, choose to cede to the residual market.

The increase in both the number of policies ceded to CAR and the amount of its deficit has been triggered in large measure by rate inadequacy, or insurance companies' perception of rate inadequacy. As the Commissioner acknowledged in the remand decisions for 1987 and 1988, the rates for at least those two years were inadequate. However, despite the increases in the rates for 1987 and 1988, and the successful, cost-saving 1988 reform legislation, the number of risks ceded to CAR has increased again in 1989, and by the end of the year, almost 70 percent of the risks are predicted to be ceded to CAR. In my recent discussions with individual companies as part of the Section 66 consultation process, I have learned that there still persists the belief by many companies that rates are not adequate. More troubling is the fact that sometimes this belief has been fostered in part by apparent communication problems within the industry. Some companies appeared to be uninformed about the fact that their own rating bureau had stipulated to a rate reduction to reflect changes in the reform law and even about the fact that the final rate set by the Commissioner for 1989 was only about 2 percent lower than the industry's final recommendations.

Based on developments thus far in the 1990 rate proceedings, it appears that the industry's rating bureau, the Massachusetts Automobile Rating and Accident Prevention Bureau ("MARB"), is making determined efforts to correct any communication problems and to improve communications between

itself and CAR, and between itself and the Division. This effort is vital in order to continue improving the auto insurance climate in Massachusetts.

2. Rule 11

Rate adequacy is not enough, in and of itself, to bring about depopulation of CAR. Rule 11 of the CAR Rules of Operation, which establishes the formula for allocating the CAR losses and expenses among member companies, is another significant factor affecting company cession strategies, the number of policies ceded to CAR, the CAR deficit, and companies' withdrawal decisions. As is discussed in more detail in Section II.A.3., since the inception of CAR, Rule 11 has imposed caps on companies' minimum and maximum share of the deficit in order to provide incentives to companies for increasing, and disincentives for reducing, market share. A number of companies have challenged the Rule 11 caps, primarily because they feel that the lower cap is too restrictive and does not allow them to reduce business significantly. However, for the majority of companies between the upper and lower caps, Rule 11 has had a major, and probably inadvertent, effect on increasing company cessions. When the CAR deficit became very large, the fact that the deficit was allocated on the basis of purely voluntary business created a strong economic incentive for companies between the caps to attempt to reach their lower cap, by increasing their cessions, instead of attempting to reach the upper cap, by increasing their voluntary business. This phenomenon has led to the growth of CAR.

The eight companies that have withdrawn or are attempting to withdraw from Massachusetts over the past three years have each cited both the inadequacy of the rates and Rule 11 as their primary reasons for abandoning their Massachusetts business.

D. <u>Goals, Objectives and Standards of CAR Reform</u>

To achieve the statutory goals established by Section 66, the Division has identified a number of subsidiary objectives and standards by which to measure the various proposals submitted by CAR, the American Insurance Association ("AIA") and others that form the basis for this report. They are as follows:

1) <u>Fairness</u>: The proposal must be fair to all participants in general and must not seriously disadvantage any particular interest, group or person. There is a widespread perception that the current system is unfair to many participants.

2) <u>Simplicity</u>: The proposal must not be so complex that it is too difficult for many participants to utilize, and it must not make the current system needlessly more complex. Most would agree that the current system, especially Rule 11, is too complicated, so complicated, in fact, that it is very difficult even for sophisticated and knowledgeable insurance professionals to understand and apply.

3) <u>Effect on Market Stability</u>: The proposal must not adversely affect market stability. In light of the current

instability in the market, each proposal must make the market more stable than it is now.

4) <u>Compatibility with Competitive Rating</u>: Each proposal must be evaluated to determine whether it would make a return to competition more difficult, and any negative effect must not be so serious as to create a significant obstacle to a return to competitive rating. The proposal must be consistent with a competitive system or a continuation of fixed and established rates.

5) <u>Rate Neutrality</u>: A proposal must be rate neutral -- that is, it does not have a material rate impact on any classification or territory.

6) <u>Effectiveness</u>: Finally, and most importantly, each proposal must be effective in that it furthers depopulation of CAR. In other words, it must reduce the number of risks ceded to CAR and reduce the deficit. It must also contribute to containing costs.

E. <u>Consultation Process</u>

The process for developing this proposal began very shortly after Section 66 was enacted into law. Over the past eight months, the Commissioner has held two hearings designed to solicit proposals and receive comments on proposals; has thoroughly reviewed and evaluated the written proposals submitted to the Division; has retained Tillinghast, an independent actuarial and consulting firm, to test the effects on the industry in general and on each company of the CAR

Governing Committee reform proposals, of some of the proposals suggested by other parties and the final recommendations for CAR reform; has held numerous meetings with domestic and foreign insurance companies and other interested participants to discuss, among other things, the automobile insurance system in general and CAR reform in particular; and has monitored the development of the CAR recommendations.

1. May and August Hearings:

On April 25, 1989, the Division issued a notice of a public hearing, which was held on May 24, 1989 at the Division of Insurance, to solicit proposals for implementing the reforms contained in Section 66.

The May hearing was extremely well attended. Oral and/or written testimony was presented by the following individuals or representatives: Lieutenant Governor Evelyn Murphy; Senator John Houston; the Attorney General; CAR; industry associations - the American Insurance Association ("AIA"), the Alliance of American Insurers; insurance companies - Arbella Mutual Insurance Company, CNA Insurance Companies, Utica Mutual Insurance Company, The Travelers, Commerce Insurance Company, the Hanover Insurance Company, Liberty Mutual Insurance Company, Metropolitan and Liability Insurance Company, Safety Insurance Company, Norfolk and Dedham Group, Trust Group, Inc., Holyoke Mutual Insurance Company in Salem, United States Fidelity and Guaranty Insurance Company ("USF & G"); agents' associations - the Independent Insurance Agents of

Massachusetts ("IIAM"), Professional Insurance Agents of New England ("PIA"), Massachusetts Automobile Insurance Agents Association, Inc.; and other interested parties - Massachusetts Public Interest Research Group ("MASSPIRG"), Gordon Owades and Leonard Fisher.

The testimony identified a number of issues for exploration, including the following: the efficiency and cost-containment potential of loss-sharing residual market mechanism as compared to a risk-sharing residual market mechanism; the structure and representativeness of the CAR Governing Committee and its subcommittees; the equity of the CAR Rule 11 allocation formula and the Rule 12 credits; the need for adequate depopulation incentives, for example, cession limits and credits for taking business out of the residual market; the propriety of the additional servicing carrier expense reimbursement for Code 03 producers; the concept of all companies becoming servicing carriers with the ability to buyout of the status; the need and criteria for a separate CAR rate; the commission rate for agents for residual market business; the need to establish criteria for becoming an ERP; and the need for rate adequacy and/or competitive rating. While everyone who testified at the May hearing agreed that there were many serious problems with the current residual market, they expressed widely divergent views on appropriate solutions. At that time, it appeared that consensus was unlikely.

In late July, CAR and the AIA submitted detailed proposals to the Commissioner containing their recommendations for implementing Section 66. On July 27, 1989, the Division issued a notice of a second public hearing, which was held on August 9, 1989, to afford all interested parties an opportunity to comment specifically on the CAR and AIA proposals, as well as on any other proposals which had been submitted to the Division, or to make additional proposals for implementing Section 66.

The August hearing was also very well attended. Oral and/or written testimony was submitted by the following individuals and representatives: Senator John Houston, the Attorney General, CAR, AIA, United States Fidelity and Guaranty Insurance Company, The Travelers, Hanover Insurance Company, Utica Mutual Insurance Company, CNA Insurance Companies, IIAM, PIA, MASSPIRG and Massachusetts Citizen Action. The testimony at the August hearing differed slightly from the May hearing because some company representatives appeared to coalesce around the AIA proposal. These companies, which for the most part are foreign companies, were united in advocating a change to the current Rule 11. Even The Travelers, a company that is represented on the CAR Governing Committee, testified in favor of changing Rule 11 as soon as is practicable, despite the fact that the CAR proposal did not address Rule 11.

2. Review and Evaluation of Written Submissions

Most of the individuals and representatives testifying at the two hearings filed written submissions with the Division. Some of the written testimony was identical to the oral testimony presented by the individual or representative and other written submissions contained more detailed recommendations. In addition to the written submissions filed by the individuals testifying at the hearings, the Division received numerous other written submissions from individuals, legislators, companies and associations. The written submissions were very helpful in suggesting and evaluating the various options.

3. Tillinghast Engagement

To help the Division achieve a result that was both objective and fair to all participants, the Division decided that it was important to have independent outside experts evaluate and analyze all the relevant data. To this end, the Division suggested that CAR pay the expenses for such expertise and that the Division and CAR mutually agree on the firm and on the scope of the work. The Division and CAR agreed to retain the actuarial and consulting firm of Tillinghast, which had previously done work for CAR in developing CAR commercial auto rates, to provide expert assistance to the process. Tillinghast began its engagement on May 29, 1989, with the approval of the Division and the CAR Governing Committee. The findings and conclusions of Tillinghast are discussed in

Section V below and a copy of the final Tillinghast report is attached as Appendix A.

4. <u>Meetings with Interested Participants</u>

To fulfill the mandate of Section 66 that the Commissioner consult with CAR, agents, companies, the Attorney General, representatives of consumer groups and other interested parties about the issues raised by the legislative mandate, former Commissioner Singer, and after his resignation, present Commissioner Gailey, held a series of meetings with all the interested participants to explore the issues both generally and specifically. Dozens of meetings have been held, consuming hundreds of hours. The input and information obtained through these meetings have been of great value and have significantly contributed, along with the excellent work of the Tillinghast firm employees, to the development of an effective and fair final product.

5. <u>The CAR Process</u>

The Commissioner encouraged CAR to discuss recommendations for implementing Section 66 in the early part of the year and closely monitored the developments at CAR. The CAR Governing Committee appointed a Depopulation Advisory Committee for the purpose of developing recommendations to make to the Governing Committee about revisions to CAR which would implement Section 66. The CAR Depopulation Advisory Committee met on a regular basis from March 1989 through July 1989. Representatives from the Division attended all of the meetings and participated as requested or appropriate.

On May 9, 1989, the CAR Depopulation Advisory Committee approved a statement of goals concerning depopulation, deficit reduction and cost containment, and potential methods for attaining those goals. The statement was approved by the CAR Governing Committee and presented to the Commissioner at the Division's May 24, 1989 hearing. CAR's initial proposal was modified and subsequently approved by the Depopulation Advisory Committee on July 11, 1989. After discussion, the Governing Committee modified and then formally approved the submission to the Division of CAR's July 26, 1989 proposal for implementation of Section 66. The final CAR proposal is attached as Appendix B. CAR testified about its final proposal at the Division's August 9, 1989 hearing.

From May through August 1989, the Commissioner, representatives from CAR and the Tillinghast consultants met numerous times to discuss the assumptions and the model used by Tillinghast to test the effects of the various CAR and Division options for CAR reform, as well as to discuss the results the model generated.

The CAR Governing Committee held a special meeting on August 23, 1989 so that I could present an overview of the CAR reforms I then intended to recommend in this report which went beyond the CAR recommendations. The purpose of the meeting was both to inform CAR and also to provide the members of CAR with an opportunity to comment on my proposed reforms, both collectively and individually. Subsequent to the special

meeting, I held additional meetings with individual members of the Governing Committee.

II. BACKGROUND

A. History and Structure of CAR

Automobile insurance is compulsory in Massachusetts, and the Legislature has also mandated that motor vehicle insurance be made available to all qualified applicants. See, G.L. c. 90, §§34A-J; c. 175, §113H. Risks that insurance companies voluntarily agree to assume constitute the "voluntary market." Residual market mechanisms exist to provide insurance to those drivers who are unable to obtain insurance in the voluntary market. The risks in the "involuntary market" or the "residual market" are shared by the industry as a whole. The existence of a residual market mechanism for automobile insurance guarantees universal access to such insurance. The residual market is sometimes known as the "high-risk pool." However, as will be more fully explained below, CAR is not comprised of only high-risk drivers.

Massachusetts has had a residual market mechanism for automobile insurance since 1939. Residual market mechanisms for automobile insurance currently exist in all states, regardless of their regulatory scheme. However, the type and structure of the mechanisms differ. Massachusetts has a unique history of automobile insurance regulation, which includes experimentation with a number of different types of residual market mechanisms over the past fifty years.

It is important to note that the residual market does not operate independently of other forces in the automobile insurance market. The size of the residual market has been affected over the years not only by the structure of the market itself, but also by the industry's perception of the adequacy of the automobile insurance rates, the companies' assessment of the regulatory environment in the Commonwealth and legislative reforms to the automobile insurance system.

1. Assigned Risk Plans

For the years 1939-1974, Massachusetts had an assigned risk plan. These are the oldest and most common type of plans in use throughout the country. Under the Massachusetts assigned risk plan, a driver who was rejected by a number of insurance companies would apply directly to the plan, which had offices in various parts of the state, or would obtain insurance through an assigned risk broker who specialized in placing high risks. The assigned risk plan would assign the risk to an insurance carrier, based on market share. The company assigned to a risk collected the premium, issued a policy in its name and was responsible for all of the expenses and losses related to that risk.

A number of structural changes were made to the assigned risk plan during its period of operation in Massachusetts. Prior to 1953, the assigned risk plan operated in Massachusetts on a voluntary basis. Chapter 570 of the Acts of 1953 first established an assigned risk plan by law. The stated purpose

of the first statutorily-based plan, known as the Massachusetts Motor Vehicle Insurance Plan ("the Plan"), was to provide for the fair and equitable apportionment among authorized insurance companies of eligible applicants for insurance who were in good faith entitled to and unable to procure motor vehicle liability insurance through ordinary methods. Drivers were not eligible for coverage through the Plan if a prior policy had been cancelled for any reason, including non-payment of premium, or if the driver had certain types of traffic violations or convictions. During the early years, the Plan offered only limited coverages, such as in-state bodily injury liability and limited uninsured motorist coverages. Additional coverages could be purchased after assignment. By 1971, the Plan was required by law to offer both liability and physical damage coverages.

The assigned risk plan had incentives to encourage companies to retain existing business. For example, primary and secondary quotas were set to determine how many assigned risks a company would be required to accept. In addition, a system of credits was created to encourage companies to voluntarily insure previously uninsured and younger drivers.

There were a number of problems and abuses associated with the assigned risk plan in Massachusetts. The requirement that insureds be rejected by several companies resulted in delays and inconvenience for consumers in obtaining coverage. The separate classification of assigned risk drivers created a

stigmatized class of drivers. There was also a great deal of abuse of the assigned risk plan system by brokers. For example, there were brokers who rubber-stamped policies "rejected" to circumvent the requirement that applicants receive a number of insurance company rejections. Because assigned risk plan brokers were not entitled to receive renewal commissions, some Plan brokers charged insureds additional fees, which they called service fees, such as a $10 charge to expedite the handling of an insurance application. In 1971 the Division of Insurance held approximately 70 hearings resulting in the revocation of the licenses of over 50 Plan brokers because of abuses.

2. The Reinsurance Facility

Chapter 551 of the Acts of 1973 replaced the assigned risk plan with a reinsurance facility, which was known as the Massachusetts Motor Vehicle Reinsurance Facility ("the Facility"). All companies were required to become members of the Facility. The major structural difference between an assigned risk plan and a reinsurance facility is the change from a risk-sharing mechanism to a loss-sharing mechanism. Under a risk-sharing mechanism, the company that is assigned an involuntary risk collects the premium and is responsible for the losses associated with that risk. Under a loss-sharing mechanism, the premiums, losses and expenses for ceded risks are shared by all the companies. It was anticipated that the more centralized Facility would operate more efficiently and eliminate the stigma and abuses associated with the assigned risk plan.

Under Chapter 551, all companies were required to accept all eligible applicants for insurance. This came to be known as the "take-all-comers" law. The companies were then allowed to cede those risks they did not want to insure in their voluntary books of business, regardless of the insured's driving history/record. The company was responsible for issuing the ceded policy in its own name and for servicing it in the same manner as it serviced the policies it retained voluntarily. However, the premiums, losses and expenses for the ceded risks were shared by all companies. In addition, Chapter 551 created a new category of brokers, known as designated brokers. These were agents who had no voluntary contracts with any companies. They were ostensibly located in areas where there were a considerable number of "high risk" insureds, such as urban areas, or risks that companies for whatever reason did not want to insure voluntarily. The apportionment of losses was based on each insurer's total market share less its designated broker business.

With the creation of the Facility, the residual market began to grow. During the last year of the assigned risk plan, the residual market comprised approximately four percent of the market. By 1975, the residual market comprised almost 15 percent of the market. This dramatic increase was caused in part by the change in the structure of the residual market and in part by other forces in the marketplace, such as the rate levels for automobile insurance and a number of significant

legislative changes during the mid-1970's. Chapter 266 of the Acts of 1976, which, among other things, abolished no-fault property damage coverage and created the Merit Rating Plan, also reorganized the membership of the Facility Governing Committee and gave the Commissioner new authority with respect to the Facility. In response, in 1977 the Facility prepared and filed a new plan of operation which differed substantially from the one that governed the Facility during its first few years of operation.

Chapter 266 also established a new file-and-use rating law, which established competition for 1977. Under competition, the rates for the Facility were allowed to be set and were set higher than the rates for the voluntary market. The rates for Facility risks were set at the 80th percentile of the voluntary market rates of all companies. Moreover, because of dramatic increases in rates for some territories and classes, there were even greater increases for most Facility risks. This was particularly troublesome because there were no objective criteria for placing risks in the Facility.

Chapter 365 of the Acts of 1977, which was enacted to deal with the aftermath of the experiment with competition, made additional structural changes to the Facility and provided rebates of approximately $55 million to drivers most adversely affected by competition. Most significantly, Chapter 365 included the Lane-Bolling amendment which prohibited rates for

good risks in the Facility from exceeding the rates that would be used by each such risk's insurer for that risk if such risk were not in the Facility.

Chapter 129 of the Acts of 1982 changed the Facility Governing Committee membership and terms. Chapter 129 also provided that the Governing Committee would be responsible for the hiring of the employees of the Facility. Prior to the enactment of Chapter 129, no length was specified in G.L. c. 175, §113H, for Governing Committee members' terms of office and the Governing Committee served at the pleasure of the Commissioner. Also, prior to Chapter 129, under the Facility Plan and Rules, the Governing Committee appointed officers of the Facility and the appointment, removal and salaries of Facility officers were subject to approval by the Commissioner. After the enactment of Chapter 129, the Governing Committee filed proposed amendments to the Facility Plan and Rules which would have abolished the Commissioner's approval authority over Facility Governing Committee decisions regarding the appointment, removal and salaries of the Facility officers. After a hearing, the Commissioner disapproved the amendments removing his authority. CAR commenced a legal action in Superior Court, arguing that the Commissioner's interpretation of the proposed amendments was inconsistent with Chapter 129. The Superior Court agreed and reversed the Commissioner's decision. The Commissioner appealed. On appeal, a compromise was reached between the Governing

Committee and the Division. The current CAR Plan and Rules provide that all appointments of officers are subject to approval by the Commissioner.

The residual market continued to grow throughout the late 1970's and early 1980's. By 1982, 46.8 percent of the market was ceded to the residual market. By 1983, approximately 47.7 percent of the market was ceded to the Facility.

3. Creation and Operation of CAR

Chapter 241 of the Acts of 1983 replaced the Facility with a different type of residual market mechanism. The plan, created under Chapter 241 and known as CAR, is a hybrid of a joint underwriting association and a reinsurance facility. CAR is similar to a reinsurance facility in that it is a loss-sharing mechanism -- all premiums, expenses and losses on ceded business are shared by all the companies. However, unlike a reinsurance facility, there are a limited number of companies acting as servicing carriers. Under CAR, only servicing carriers are required to accept all applicants and can choose whether they want to voluntarily retain or cede a risk. The servicing carriers issue a policy to each applicant and remain responsible for servicing it. The companies who are not servicing carriers only accept business they are willing to assume in their voluntary book of business. Since each agent is assigned at least one servicing carrier, an applicant is able to obtain insurance through agents geographically dispersed throughout the state. Servicing carriers receive an

expense allowance from CAR as reimbursement for the expenses related to the handling of ceded business. The Legislature apparently expected that limiting the number of servicing carriers would result in more efficient and coordinated anti-fraud efforts in the residual market and a reduction in the number of cessions.

Chapter 241 allowed for a short transition from the Facility to CAR, with the new plan beginning operations on January 1, 1984, only six months after the enactment of Chapter 241. Like the Facility, CAR is governed by G.L. c. 175, §113H, a Plan, Rules of Operation and a Manual of Administrative Procedures. The Plan and Rules are subject to review and approval by the Commissioner.

CAR is an association of insurance companies whose members are insurance companies writing motor vehicle insurance in the Commonwealth. There are currently approximately 320 members of CAR.

CAR is administered by a Governing Committee, which is appointed by the Commissioner and consists of seven members from insurance companies and six members from associations of insurance producers. The Governing Committee members serve six-year, staggered terms. A list of the current Governing Committee members, their affiliations and their terms is attached as Appendix D.

The Governing Committee is responsible for implementing the CAR Plan and Rules. Another of the Governing Committee's

responsibilities is hiring the employees of CAR. The Commissioner has approval authority over the officer appointments and salary ranges. CAR currently has nine officers and approximately 111 other full-time employees. The CAR budget for fiscal year 1989 was $8,987,175. The Governing Committee and the many standing and temporary subcommittees it has established meet on a regular basis. The standing committees include the Actuarial, Budget, Claims Advisory, Commerical Lines, Defaulted Brokers, Governing Committee Review Panel, Incurred But Not Reported ("IBNR"), Legal, Operations, Personnel and Servicing Carrier Committees.

Chapter 241 of the Acts of 1983 mandated that the Governing Committee appoint not fewer than twenty servicing carriers. CAR initially appointed twenty-five servicing carriers. However, many of the eight companies that have recently withdrawn or are attempting to withdraw from the Commonwealth over the past three years were servicing carriers. Therefore, there are currently 20 servicing carriers which collectively insure approximately 90 percent of the total automobile insurance market.

Servicing Carriers are required under the CAR Plan and Rules of Operation to treat the risks under policies they cede to CAR in the same manner as the risks they insure in the voluntary market. CAR is designed to be invisible to the insured.

Under the CAR rules, each servicing carrier is required to maintain a Special Investigative Unit ("SIU") to investigate suspicious or questionable motor vehicle insurance claims. Servicing carrier SIUs are required, by the CAR Plan and Rules of Operation, to investigate suspected cases of fraudulent claims for both policies issued through CAR and voluntary policies. CAR maintains its own SIU for the purpose of monitoring the effectiveness of servicing carriers' fraud control efforts and to provide assistance upon the request of member companies.

Under G.L. c. 175, §113H, all licensed property and casualty agents and brokers issuing motor vehicle policies are entitled to be assigned to at least one servicing carrier except in the cases of agent fraud, license revocation, material breach of contract or default in the payment of premiums. These agents and brokers are called representative producers. There are two categories of representative producers, those agents or brokers who have voluntary agency or brokerage agreements with a servicing carrier and those agents and brokers who do not have a voluntary contract or brokerage agreement with any servicing carrier. The former group are assigned by CAR to represent those servicing carriers with whom they already have a relationship. The latter group are assigned by CAR to represent one servicing carrier and are known as exclusive representative producers ("ERPs"). The servicing carrier contracts with exclusive representative

producers are required to contain substantially the same contractual terms and conditions which govern the company's normal agency relationships. Today, there are approximately 1,675 active ERPs, representing approximately 23 percent of the market. At the inception of CAR, there were approximately 875 involuntary agents, known as designated brokers.

Historically, there were two categories of producers for the purpose of determining expense allowances to servicing carriers. All of the representative producers were known as CAR I.D. Code 04 producers except for those that were designated producers under the Facility. The Code 04 category included representative producers that had voluntary agreements with one or more servicing carriers and those that had no voluntary contracts with any servicing carrier. Those agents or brokers that were known as designated producers under the Facility are referred to as CAR I.D. Code 03 producers. These are agents who did not have a voluntary contract with any company prior to the inception of CAR in January 1, 1984. There are currently approximately 666 CAR I.D. Code 03's. Effective January 1, 1989, the CAR I.D. codes were expanded to nine categories for more precision.[1]

[1]Code 0 is voluntary business from voluntary agents, Code 1 is voluntary business from representative producers, Code 2 is voluntary business from affiliated agencies, Code 3 is ceded business from a former designated broker, Code 4 is ceded from voluntary agents, Code 5 is ceded from representative producers, Code 6 is ceded from affiliated agencies, Code 7 is voluntary business from a former designated broker and Codes 8 and 9, respectively, are voluntary and ceded from involuntary assigned producers that previously had a voluntary contract cancelled after November 1988.

Servicing carriers are reimbursed by CAR for the expenses related to the policies ceded to CAR. The servicing carriers receive an expense allowance for servicing ceded policies produced by Code 03 producers which is approximately 16 percent greater than for those ceded policies produced by Code 04 producers. The rationale behind this additional expense reimbursement is the assumption that the Code 03 business has a higher claim frequency and is therefore more expensive to service.

The member companies of CAR are responsible for sharing the losses and expenses incurred by CAR. Chapter 241 of the Acts of 1983 and the CAR Plan of Operation mandated that the CAR rules provide for the fair and equitable distribution of those losses and expenses through the assessment of member companies. Chapter 241 also required that the allocation of premiums, losses and expenses for the first year of operation (1984) "be based on the total number of risks written by each company during the calendar year nineteen hundred and eighty-two, excluding risks written through designated producers." For policy years thereafter, Chapter 241 provided

that "the allocation shall be based on a method so that no company materially or substantially reduces its percentage of participation by reducing its writings nor shall any company have their participation materially or substantially increased because of the action of other companies."

CAR Rule 11 establishes the formula for allocating the CAR deficit among member companies. Rule 11 contains incentives for companies to increase their share of the voluntary market and disincentives for companies to decrease their share of the voluntary market. However, it may inadvertently also create incentives to cede business to CAR rather than retain it voluntarily. Each company's share of the deficit is called its participation ratio.

Chapter 241 also required the plan to provide credits for those companies voluntarily writing private passenger automobile insurance within those territories and classifications that would otherwise be disproportionately represented in the plan. CAR Rule 12 establishes the specific credits for companies which are willing to voluntarily write business that is considered undesirable, for example, inner-city risks. Each company's capped participation ratio is adjusted for credits in accordance with CAR Rule 12.

In late 1983, CAR first adopted, and the Commissioner approved, a five-year transition rule for determining the CAR allocation formula. Chapter 241 mandated that the allocation formula for 1984 use 1982 as the base year, for the first year

of CAR's operation. For the years 1985-1988, the original transition Rule 11 provided that a company's participation ratio for private passenger motor vehicles be equal to its actual voluntary retained market share subject to caps based on its 1982 total voluntary market share. For 1985, the caps were plus or minus 5 percent of 1982; for 1986 through 1988, companies' participation ratios were capped at plus or minus 2 1/2 percent per year. Therefore, the caps worked as follows: for 1986, the companies participation ratios were capped at plus or minus 7 1/2 percent of 1982; for 1987, plus or minus 10 percent of 1982; and for 1988, plus or minus 12 1/2 percent of 1982.

The transition Rule 11 also contained incentives for companies to begin writing automobile insurance. Rule 11 provided that "newly-emerging" companies, those companies which at the time of licensure had neither previously written private passenger or commercial automobile insurance, were to have first-year participation ratios equal to one-half of their first-year voluntary writings divided by the total industry voluntary writings. For the following years, the regular Rule 11 caps were applied to their first-year participation ratios. For companies "newly writing" during the transition period, those companies that did not qualify as newly-emerging companies and which did not write private passenger and/or commercial automobile insurance in 1982, their participation ratios were equal to their first-year voluntary writings

divided by the total industry voluntary writings. For the following years, the regular Rule 11 caps were applied to their first-year participation ratios.

The current Rule 11 for private passenger vehicles, amended by the Governing Committee and approved by the Commissioner in late 1987, has been in effect since January 1, 1989. It contains a formula whereby a company's participation ratio is equal to its actual voluntary retained market share subject to a cap of plus or minus 5 percent. For policy year 1989, a company's participation ratio is capped at plus or minus 10 percent of its 1986 capped participation ratio. For each policy year thereafter, the lower cap is minus 5 percent of the prior year's capped participation ratio. For 1990, the upper cap is is plus 5 percent of the company's 1989 capped participation ratio; for 1991 plus 10 percent of the company's 1989 capped participation ratio; for 1992 plus 15 percent of the company's 1989 capped participation ratio; etc.

The current Rule 11 also contains what are referred to as "catch-up" provisions. These are designed to ensure that companies which are paying much less than their voluntary retained market share because they are above their upper cap, pay at least 30 percent of the company's 1989 voluntary market share, 40 percent of the company's 1990 voluntary market share, 50 percent of the company's 1991 voluntary market share and 60 percent of the company's voluntary market share for 1992 and subsequent years.

The current rule also contains revised provisions for newly-emerging and newly-writing companies. Companies newly emerging in 1987 and later are subject to a special formula for five years which requires the company to pay 20 percent of its voluntary retained exposures in the first year, 40 percent in the second year, 60 percent in the third year, 80 percent in the fourth year and 100 percent in the fifth year. After the fifth year, the company's participation ratio is capped at plus or minus 5 percent of the prior year's participation ratio. Companies newly writing in 1987 and thereafter are subject to a special formula for five years which requires the company during that time to pay its actual voluntary retained market share. After the fifth year, the company's participation ratio is capped at plus or minus 5 percent of the prior year's participation ratio.

The current rule, revised in 1987, attempted to address some of the complaints that had been lodged against the transition rules. For example, it loosened the upward and downward caps, established catch-up provisions for companies paying much less than their actual voluntary market share and changed the benefit for newly-emerging and newly-writing companies. However, a number of companies remain dissatisfied with the current rule because it is still loosely based on 1982 voluntary market share, it contains caps and it continues to afford benefits, which they argue are too great, for growing companies. They argue that the upper caps are still only

realistically available to small companies, which they contend are the only ones that can afford to grow rapidly. These larger companies generally believe that the allocation formula should be based on actual voluntary market share or on a formula which more closely mirrors actual voluntary market share.

4. Growth of CAR

Since CAR's inception in 1984, the total private passenger automobile insurance market has grown in exposures, increasing by 5.0 percent from 1983-4, by 4.0 percent from 1984-5, by 2.8 percent from 1985-6, by 4.4 percent from 1986 to 1987, and by 1.3 percent from 1987-1988. The number of exposures ceded to the residual market has grown by even greater percentages during this same time period, and the residual market has grown as a percentage of the total market. In 1984, 1,340,804 private passenger exposures were ceded to CAR which resulted in a 45.2 percent private passenger cession rate. Even though the number of private passenger exposures ceded to CAR increased from the two prior years, the private passenger cession rate for 1984 was lower than the 46.8 percent cession rate in 1982 and the 47.7 percent cession rate in 1983. In 1985, the number of private passenger exposures ceded to CAR increased to 1,526,945 and the cession rate increased to 49.5 percent. In 1986, the number of private passenger exposures increased to 1,726,403 which resulted in a 54.4 percent cession rate. In 1987, the number of private passenger exposures increased to

1,949,216 which resulted in a 58.9 percent cession rate. In 1988, the number of private passenger exposures ceded to CAR increased to 2,146,775 which resulted in a 64 percent cession rate. For 1989, the cession rate is expected to approach 70 percent. The CAR deficit has also grown significantly and disproportionately from $306,489,000 in 1984 to $446,945,000 in 1985 to $522,666,000 in 1986 to $474,000,000 in 1987 to an estimated $534,000,000 in 1988.

5. Public Policy Objectives Promoted by CAR

While there is understandable concern about the increasing number of risks ceded to CAR and the increasing deficit, CAR has been successful in preserving and promoting a number of important public policy objectives. The current system has been successful in assuring that insurance is readily available and generally affordable for all consumers, despite the departure of carriers which insured approximately 25 percent of the market. Because representative producers are dispersed throughout the state, consumers can readily obtain automobile insurance, regardless of whether their particular policy is ceded to CAR or not. There is no indication that insureds whose policies are ceded to CAR are treated any differently than insureds whose policies are retained voluntarily by companies.

The company withdrawals could have created massive turmoil in the market because many agents and 25 percent of the private passenger risks had to be reassigned to other companies.

However, CAR successfully managed to control the disruptive effect of the withdrawals. Due to the CAR structure, the vigorous efforts of the CAR staff and Governing Committee and the cooperation of the remaining servicing carriers, the withdrawing companies' agents were reassigned fairly quickly, and generally consumers did not experience any lapses in coverage.

The Lane-Bolling amendment, which prohibits a separate rate for good risks ceded to CAR is a unique and essential component of the Massachusetts automobile insurance system. It ensures that consumers whose automobile insurance policies are ceded to CAR are not charged a higher rate simply because they are ceded. With more than two-thirds of all risks currently insured through CAR, there are obviously good drivers whose policies are being ceded. It would be unfair and against public policy to penalize good drivers whose policies, due to company ceding strategies or underwriting strategies which may not comport with public notions of fairness or equality, end up in CAR.

The manner in which the CAR deficit is currently accounted for in the automobile insurance rates is also an important provision in the law that makes our system unique and promotes fairness and equity. The CAR deficit is flat-loaded into the rates. This means that all insureds pay an equal portion of the deficit as part of their premium, no matter where they live or what type of vehicle they drive.

B. The Market in which the CAR Reforms Must Operate

1. Overview

For over three years, the Massachusetts automobile insurance market has been in a state of turmoil. The public's perception of the state of the market and the intensity of the crisis has ebbed and flowed as conditions changed. Despite CAR's efforts, during this time approximately 25 percent of the drivers in the state have been forced to find new auto insurance carriers because of the departure from the market of eight companies. Agents have had to switch carriers, often with difficulty, and the capacity of the remaining companies, in capital, personnel and other resources has been strained. The increasing number of departures has forced the remaining companies to consider seriously whether they can remain in Massachusetts; none wants to be among the last remaining with continuing and unacceptably high levels of losses in Massachusetts automobile insurance.

Moreover, as companies have withdrawn, the negative effects of M.G.L. c. 175, §22H ("Section 22H") are beginning to surface. Section 22H requires the Commissioner to suspend the authority to transact business in the Commonwealth of any company which refuses to write auto insurance if the refusal to write is disruptive, unless the Commissioner has determined that the refusal is justifiable to protect the solvency of the insurer. Section 22H also permits the Commissioner to treat

all insurers who are part of an insurance company group as a single insurer. However, in enforcing Section 22H, the Division is cognizant of the adverse impact on non-auto markets of companies withdrawing entirely from the property and casualty business in the Commonwealth. Of particular concern are those markets which are specialized and have a limited number of outlets or participants. Accordingly, the Division recognizes that there must be a delicate balancing of interests in enforcing Section 22H, and the impact on other markets must be considered.

For the 1987 and 1988 policy years combined, Massachusetts consumers paid a premium that was on the average 25.7 percent greater than the average 1986 premium. While Massachusetts consumers are rightfully upset about these increases, it should be noted that consumers in other states have experienced much more dramatic rate increases over the past few years. In part, Massachusetts drivers have been shielded somewhat from similar, and more likely even greater, increases because of our unique regulatory structure, which is undoubtedly the most restrictive in the country. Massachusetts is the only state where the state both sets the rates for the entire private passenger market and where the rates for good drivers in the residual market are required to be the same as for those in the voluntary market. The combination of these constraints has prevented Massachusetts consumers from feeling the full impact of the types of rate increases that companies have obtained in

other states and have sought here. These constraints have also been a principal cause of the departure of the eight companies which have exited the Massachusetts market in the last three years.

2. <u>1985-88 Rate Decisions and SJC Decisions</u>

For policy years 1985, 1986 and 1987, the industry requested rate increases of 7.9%, 12.0%, and 33.7%, respectively. The Decisions on 1985, 1986 and 1987 rates resulted in rate changes of -2.0%, -0.2% and 8.9%, respectively. There was growing dissatisfaction by the industry with those rates, and in 1987, for the first time since 1983, the industry appealed the Commissioner's rate decision.

On December 15, 1987, the Supreme Judicial Court reversed the Commissioner's Decision on 1987 Rates and ordered him to hold further hearings, if necessary, to set those rates. <u>Massachusetts Automobile Rating and Accident and Prevention Bureau v. Commissioner of Insurance</u>, 401 Mass. 282 (1987)("the 1987 remand decision").

On January 21, 1988, the Single Justice of the Court also remanded to the Division, for reconsideration in light of the 1987 remand decision, the appeal of the Decision on 1988 Rates. <u>Massachusetts Automobile Rating and Accident Prevention Bureau v. Commissioner of Insurance</u>, Supreme Judicial Court, C.A. No. 88-1. The remand hearings for both years were consolidated into one proceeding. The resulting remand rate

decision issued on March 10, 1988 addressed both 1987 and 1988 rates. It concluded that the record supported an additional increase of 8.3 percent for 1987, resulting in final rate increases of 18.0 percent for 1987 and 7.7 percent for 1988.

Consumers overwhelmingly opposed the additional rate increases. Literally thousands of consumers contacted the Division of Insurance to express their outrage about receiving bills for a policy year that had already passed. Many more complained about the additional increase in 1988 rates and asserted that the coverage was barely affordable prior to the increases.

3. <u>1988 Reform Legislation</u>

As a result of both consumer response to the remand billing and in recognition of an antiquated no-fault system, automobile insurance reform legislation topped the list of legislative priorities for the 1988 session. No less than six major reform packages were debated in the Legislature before the final adoption of what became Chapter 273 of the Acts of 1988. Chapter 273 was without question the most significant consumer-oriented legislation in the automobile insurance area since the adoption of No-Fault in 1970.

4. <u>Company Withdrawals</u>

Over the past few years, nine insurance company groups have announced their intention to withdraw or have withdrawn from the Commonwealth. The nine insurance company groups are referred to herein as Peerless, Fireman's Fund, Kemper, Shelby,

General Accident, Allstate, Reliance, American Universal and the New Hampshire Insurance Group. These nine company groups consist of approximately thirty companies and represent approximately 25 percent of the automobile insurance market. The New Hampshire Insurance Group recently reversed its decision and announced that it will stay in the Commonwealth at least through June 30, 1990. The New Hampshire Insurance Group stated that it is willing to remain in the Commonwealth to assess further the impact of recent and anticipated automobile insurance reforms, including reforms to CAR and competition.

All of the withdrawing companies have cited, as their primary reason for leaving, their current and anticipated Massachusetts motor vehicle insurance losses. All of the withdrawing companies complained about Rule 11 and their respective shares of the CAR deficit.

The Division, as well as CAR, have devoted significant resources over the past three years trying to minimize the disruptive impact of the company withdrawals. The Division has consistently taken the position that each withdrawing company must submit to the Commissioner an orderly plan for withdrawal which, among other things, describes how the company will satisfy its statutory and financial obligations in the Commonwealth. Most of the withdrawing companies have failed to submit any type of withdrawal plan. Many have attempted to surrender their licenses "effective immediately." By voluntary agreement or by court order, all of the withdrawing companies have ultimately fulfilled

their statutory requirements to give notice to agents and policyholders, and they remain responsible for fully servicing their outstanding policies, including issuing endorsements on those policies.

Since most of the withdrawing companies have been attempting to terminate their obligations to the automobile residual market as soon as possible, they have, for the most part, taken the position that their deficit obligations terminate when they announce their withdrawal. The Division and CAR have taken the position that withdrawing companies cannot unilaterally and abruptly terminate their obligations to CAR. The one principal dispute between the Division and CAR, on the one hand, and the withdrawing companies, on the other, has been the determination of the withdrawing company's proportionate share of the CAR deficit.

To date, the Division has accepted the surrender of only three of the withdrawing companies' licenses -- Fireman's Fund, Shelby and Kemper. These companies have had to pay a heavy price to withdraw from the Massachusetts automobile insurance market. By settlement agreements, Fireman's Fund paid $45 million dollars to CAR, and Shelby paid $8,596,127 to CAR, to satisfy the companies' respective financial obligations to the residual market. Kemper contributed $119 million and additional capital, resulting in a total contribution of approximately $140 million, to fund a new domestic insurance company, Arbella Mutual Insurance Company. Kemper transferred its homeowners and automobile business to Arbella and Arbella assumed Kemper's share of the CAR deficit from

October 1, 1988 on. Arbella offered employment to Kemper's employees and contracts to Kemper's agents.

The Division is currently engaged in negotiations with General Accident, Reliance, Allstate and American Universal concerning these companies' proportionate share of the CAR deficit.[2]

The company withdrawals have severely taxed the resources of the remaining companies, disturbed agents' relationships with companies and policyholders, caused confusion among policyholders, and disrupted the market generally.

The company withdrawals have also been a significant factor in the growth of the residual market. Almost all of the withdrawing companies were servicing carriers. Therefore, upon termination of each company's status as a servicing carrier, all of the agents that had been assigned to that company had to be reassigned to the remaining companies. Because these reassignments were made quickly to preserve the stability of the market, the companies that had to absorb the business did not have the time to make underwriting decisions about whether or not to cede a particular risk to CAR. Therefore, most, if not all, of the business of the withdrawing companies, including the business that the withdrawing companies might have written in their voluntary books of business, has been ceded to CAR.

Moreover, most of the remaining companies were not willing under the existing market conditions to offer agents voluntary

[2] See Appendix E for a detailed description of each of the company withdrawals.

contracts. Therefore, many representative producers who had voluntary contracts with withdrawing company servicing carriers were unable to obtain voluntary contracts with the remaining servicing carriers. These agents became involuntary agents and had to be assigned a servicing carrier by CAR. The number of involuntary market agents has grown dramatically from 875 in 1983 to 1,408 in 1987 to 1,675 in 1989.

5. Rule 11 Challenges

There was little, if any, controversy surrounding the adoption of Rule 11, when it was first proposed and adopted in late 1983. Several years later, a number of companies have alleged in a variety of civil actions that the transition Rule 11 allocation formula, the rule in place from CAR's inception in 1984 through 1988, was unfair, illegal and unconstitutional.[3] The complaints alleged that certain companies' share of the deficit is based on the company's 1982 total voluntary market share for six years after 1982, that the downward caps imposed on companies'

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[3]The transition Rule 11 is loosely based on each company's voluntarily-retained market share each year. However, the rule contains upward and downward caps, based on each company's total voluntary market share in 1982, which determine each company's minimum and maximum participation ratio each year. The 1982 total voluntary market share includes all of the business that was produced by the company's voluntary agents, regardless of whether or not the company chose to cede it. The transition and current Rule 11 are described in more detail in Section II.A.3.

participation ratios are too narrow and that the rule affords too many benefits to newly-emerging and newly-writing companies. The companies argue further that only a few companies, which happened to have had a small market share in 1982 but which had access to enough capital to expand rapidly, were able to benefit disproportionately from the Rule 11 incentives for growth.[4]

CAR has intervened in virtually all of the withdrawing company and Rule 11 litigation and has played a crucial and effective role in defending its rules. The Division and CAR have successfully litigated each of the withdrawing company and Rule 11 cases that have been decided to date.

III. BEGINNING THE RETURN TO STABILITY

In the past two years, there have been positive signs that market conditions are beginning to improve and that stability can gradually be restored. The rate increases for 1987 and 1988, which so troubled consumers, also cut into projected industry losses. Last year, the Legislature enacted significant reforms which will not only help to provide long-term stability, but are also beginning to have an immediate impact. More recently, the New Hampshire Insurance Group, which is part of the American International Group of insurance companies, decided not to withdraw from Massachusetts at least until June 1990 to allow sufficent time to assess the changes we are making in the system,

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[4]See, Appendix E for a detailed description of the Rule 11 litigation.

including the CAR reform package. In addition, I have decided to begin the 1991 competition hearing in January 1990, the earliest that the Division has ever begun these hearings, to allow suffcent time to explore and potentially resolve the problems which may prevent a return to competition on a limited basis in 1991. Finally, the industry's rate request for 1990 is the lowest rate increase requested in four years and less than half the average industry rate request for the previous three years. This appears to signal a positive change in our loss experience.

A. Implementation and Effects of the 1988 Reform Law

1. Updating no-fault and deductibles for inflation

Chapter 273 of the Acts of 1988, An Act Relative to Motor Vehicle Insurance, was signed into law on November 5, 1988 ("the 1988 Reform Law"). The 1988 Reform Law provides consumers with substantial benefits by updating the antiquated no-fault law which, when enacted in 1970, succeeded for a number of years in speeding up payments to injured persons while reducing bodily injury claims and premium costs.
However, the no-fault law had no permanent mechanism to adjust itself for inflation and therefore it did not reflect the years of soaring medical costs which ensued.

The 1988 Reform Law addresses these rising costs through both tort law changes, such as an increase in the tort threshold from $500 to $2000, and coverage changes. Personal Injury Protection ("PIP") was increased from $2,000 to $8,000, and the reform law mandated the coordination of benefits

between health insurance and PIP coverage. Additional coverage changes and available discounts have also resulted in reduced premiums for consumers. The 1988 Reform Law increased the standard deductible from $300 to $500 for both collision and comprehensive coverages and created an optional $100 glass deductible. Anecdotal evidence indicates that this change alone has had a significant impact by reducing claim frequency in 1989, and has led to more "curbside settlements." Additional rate reductions are now available for consumers with cars equipped with both an anti-theft device and an auto recovery system, and for cars equipped with air bags or passive restraint devices.

2. <u>Anti-fraud programs</u>

Section 53 of the 1988 Reform Law required the Commissioner to issue regulations implementing the first comprehensive pre-insurance inspection program in the Commonwealth. The pre-inspection regulation, which is modeled after the highly successful New York program, is designed to deter fraudulent theft and physical damage claims by requiring insurance companies to inspect and photograph newly insured used cars before they issue theft or collision insurance.

The pre-inspection regulation, codified as 211 CMR 94.00, became effective on March 1, 1989 and has to date resulted in the inspection and photographing of over 200,000 cars at over 500 inspection sites throughout Massachusetts. The regulation requires most used vehicles to be inspected before either

collision or theft insurance can be issued. There are exceptions which include vehicles over seven years old, new cars purchased from a dealer, customers who have been with the company for several years or for whom obtaining an inspection would cause a serious hardship.

The New York program, which has been in effect for 11 years, has resulted in a dramatic reduction in fraudulent automobile theft claims, with corresponding savings in the millions of dollars. The success of the New York program, and the promising results thus far achieved in Massachusetts, have fostered serious interest from other states wishing to implement pre-inspection programs.

3. Controlling auto repair costs

Sections 24 and 51 of the 1988 Reform Law amended G.L. c. 90, §34O and c. 175, §113O, to allow insurance companies to submit direct payment and referral plans to the Commissioner for approval. Such plans, to be developed on a voluntary basis, pursuant to regulations adopted by the Commissioner, were intended to contain costs by providing consumers with an alternative method of payment for their collision and comprehensive claims for auto damage repairs. The traditional method, requiring the insurer to negotiate with the repair shop after the repairs have been completed, is still an option. However, the new direct payment and referral plans allow insurers to issue a check directly to the consumer, along with a list of geographically convenient repair shops with which the

insurer has reached an agreement in advance to guarantee the cost and quality of the repairs. While the consumer retains the option to take the car to a shop not on the list, the insurer will not guarantee the cost or quality of the repairs at unlisted shops. Twelve companies, representing nearly 70 percent of the private passenger market, have since implemented direct payment plans. The MARB and the SRB have stipulated to rate savings of 3 percent in 1990 due to the prompt implementation of this reform measure, over and above those savings already realized in 1988 as a result of measures implemented by the industry in response to Division cost-containment hearings.[5] At the request of the Senate Chairperson of the Joint Committee on Insurance and others, the Division has continued to work with the MABA, along with representatives of the insurance industry and consumer groups, to improve the direct pay system, assuring both continued savings to consumers and fairness to the auto body repair industry.

[5]It should be noted that the Massachusetts Auto Body Association ("MABA") sued the Division in January 1989, alleging, among other things, that the regulations and the approved plans violated the spirit and letter of the 1988 Reform Law. The Superior Court refused to issue a preliminary injunction, but has not yet issued a final ruling on the matter. MABA, Inc. v. Commissioner of Insurance, Suffolk Superior Court, C.A. No. 89-0495E.

B. Competition Decision

In accordance with G.L. c. 175E, §5, a hearing is held in the middle of each year at which time the Commissioner examines whether there should be competition for the next rate year. For the past twelve years, the Commissioner determined that competition had been insufficient to assure that insurance rates would not be excessive for private passenger automobile insurance. For each of those years, the Commissioner ordered that rates for the following year be fixed and established.

This year the annual competition hearing was held in May and a decision was issued in June. During this year's competition hearing, proposals submitted by the Attorney General, the MARB, AIA, and CNA Insurance Companies recommended that I introduce some form of limited competition in the 1990 rate year: flex-rate bands for the optional coverages, for example. I did not implement any type of competition for the 1990 rate year primarily because the market is currently in a state of flux, due to company withdrawals and ongoing automobile insurance reforms, and there was not enough time to address the technical issues concerning the interrelationship of CAR reform to competitive rating. However, I expressed a commitment to making a serious effort to develop a realistic plan to implement some form of limited competition as soon as possible, if it can be done without consumer hardship or undue disruption. Therefore, I have ordered that next year's competition hearing be commenced no later than January 31, 1990

to ensure that there is enough time during the 1990 calendar year to develop a very careful and thoughtful proposal for implementing, if possible, some type of controlled, phased-in competition by the 1991 rate year.

C. Withdrawal Regulation

On June 27, 1989, the Division promulgated a regulation on an emergency basis, 211 CMR 54.00, to govern the procedure for the surrender and non-renewal of licenses by insurers authorized to write motor vehicle insurance. The regulation came in the wake of eight insurance companies which, in the last three years, have already begun to or have completed withdrawal plans and strong and persistent rumors that a number of other unidentified companies were planning to withdraw. The regulation will control insurers' efforts to phase out their business in an orderly fashion so as to limit market disruption and preserve the rights of existing policyholders and agents.

The Division is currently in the process of reviewing the testimony proffered by various parties at the public hearing on 211 CMR 54.00 which was held on August 4, 1989. There was strong industry opposition to the regulation. In the final regulation, the Division intends to address some of these concerns.

D. New Joint AG/SRB/MARB SDIP Proposal

Section 38 of the 1988 Reform Law authorized the Commissioner to revise the Safe Driver Insurance Plan so as to allow greater credits for drivers with clean driving records

and higher premiums for drivers with bad driving records.

The plan currently being used allows "good" drivers a maximum credit of only $120.00 per year regardless of the number of "clean" driving years. "Bad" drivers are able to work off their unsafe driver points within three years regardless of the number or severity of their offenses.

The revisions being proposed jointly by the insurance industry, the Attorney General and the State Rating Bureau would dramatically enhance the credits to "good" drivers and, conversely, substantially increase the penalties for "bad" drivers. The proposed plan is modeled after highly successful European plans (called "bonus/malus" plans) and is most easily compared to the steps on a ladder.

The proposed plan, if adopted by the Commissioner, would move drivers up and down the ladder based on their driving records, with "good" drivers dropping down one step per "clean" driving year and "bad" drivers moving up by the number of steps assigned to a particular type of moving violation or accident. Under the proposed plan, each step of the ladder would represent either a decrease (for "good" drivers) or an increase (for "bad" drivers) of 7 percent of their liability premiums and 5 percent of their collision premiums.

The proposed plan includes a formula for transferring drivers from the current plan to the new system as well as a provision which rewards formerly "bad" drivers who have maintained "clean" driving records for five consecutive years.

The proposed plan creates an incentive for "bad" drivers to change their driving habits since the effect of each accident or moving violation is cumulative, meaning that drivers who continue to be involved in accidents or continue to receive moving violations could potentially reach the highest point on the ladder (Step 36) and thereby be paying substantially higher liability and collision premiums than most drivers. Conversely, "good" drivers are rewarded for every year of clean driving with commensurately larger savings every year.

E. New Hampshire Insurance Group Departure and Return

In the space of just over four months this year, the New Hampshire Insurance Group announced its intention to withdraw entirely from Massachusetts and then postponed the effective date of its decision for a year because of the perception that market conditions are improving. This perception was in no small part due to consideration of proposals similar to the ones contained in this report. Following the New Hampshire Insurance Group's original announcement at the end of March that they were allowing their licenses to expire effective July 1, 1989, the companies agreed in May to extend the licenses through September 1988. In August, they decided to extend the licenses at least through June 1990 to allow enough time to evaluate the CAR reforms I am now proposing and other changes in the market currently under consideration. This is an especially positive development because the New Hampshire companies are part of the American International Group ("AIG"),

one of the largest property and casualty insurance groups in the country and reputed to be a leader in the industry, and the departure of the New Hampshire Insurance Group might have required the Division to commence a proceeding under Section 22H against the AIG members due to the fragile state of the automobile insurance market.

IV. RECOMMENDATIONS OF THE PARTICIPANTS

The following is a summary of the more detailed Section 66 proposals which were submitted to the Division by the Attorney General, the American Insurance Association ("AIA") and CAR.

The Attorney General's Proposal

The Attorney General believes that in order to achieve the Section 66 goals there needs to be a major structural change in the residual market. He recommends replacing the current loss-sharing residual market mechanism with a risk-sharing mechanism. The Attorney General states that under the current CAR loss-sharing structure, the companies which pay ceded claims have no direct financial interest in the level at which claims are paid. This is because the premiums, losses and expenses for the ceded risks are shared by all of the member companies. Therefore, the Attorney General points out, while every company is injured by overpayment of claims in the residual market, no one company has sufficient incentive to put additional resources into anti-fraud programs or other measures to reduce claims overpayments. Under a risk-sharing mechanism,

he contends, the companies which pay claims will have a direct financial stake in the level at which losses are paid and thus will have an incentive to exercise good cost control. The Attorney General also states that risk-sharing mechanisms are much better suited to competitive markets than loss-sharing mechanisms.

The Attorney General's assigned risk plan would work as follows. The residual market facility would serve two roles: administrator of the random assignment mechanism and intermediary between the agent (or consumer) and the company insuring the assigned risk. All of the companies would serve as servicing carriers. Every agent and broker would have a direct contractual relationship with the residual market mechanism instead of with a particular servicing carrier.

Finally, the Attorney General proposes that the number of policies assigned to each company would be based on some type of market share formula, which, the Attorney General states, could bear as much or as little resemblance to Rule 11 as the Commissioner desired. The Attorney General contends that once the transition is accomplished (the reassignment of ceded policies from servicing carriers to all companies), the consumer would not perceive any difference between the assigned risk plan and the current system.

The Attorney General attempts to address some of the concerns that have been raised about assigned risk plans: the loss of consumer choice of company, consumer inconvenience in

obtaining insurance through an assigned risk plan, and discriminatory treatment of assigned risk claims by insurers. The Attorney General claims that since the inception of CAR, drivers in the residual market have not had a choice of company, since there are a limited number of servicing carriers. The Attorney General also states that if the assigned risk plan adopted by the Commissioner provided for the placement of assigned risk business through insurance agents, the plan would be convenient for consumers. The Attorney General further asserts that discriminatory treatment of assigned policies can be addressed by prohibiting companies from placing identifiers on assigned risk policies and claims.

The Attorney General makes a number of suggestions should the assigned risk plan not be adopted and a loss-sharing mechanism retained. These include the adoption of objective cession criteria. The Attorney General argues that instituting objective cession criteria is a better approach to depopulation than other approaches that have been suggested. He states that percentage cession limits present significant equity issues for the industry and that "dirty" rating is unfair to consumers. Under objective cession criteria, only drivers with demonstrably poor driving or claims records could be ceded. The Attorney General suggests using SDIP surcharges as one criterion and notes that objective cession criteria would have to be implemented with an explicit subsidy funding mechansim in order to be fair to insurers.

In conjunction with objective cession criteria, the Attorney General recommends that the current implicit subsidies in the rates be replaced by an explicit, funded subsidy mechanism. According to the Attorney General, under an explicit subsidy, the premiums that a company would receive would reflect the actuarially-indicated expected losses for each risk, but the consumer would generally not be paying the actuarially-indicated premium. The consumer would pay the premium established in the rates fixed by the Commissioner for each class/cell or established by competitive rating. The companies that received premium for a risk that was above the actuarially-indicated rates for that risk would have to surrender the excess premium to those companies that received premium for a risk that was below the actuarially-indicated rate. The theory behind the Attorney General's explicit subsidy is that if companies receive the subsidies implicit in the rates for each risk, they would have little, if any, incentive to cede a risk.

The Attorney General also notes that there need to be reasonable depopulation incentives for consumers and agents as well as for companies. To provide an incentive for agents to place business in the voluntary market, the Attorney General suggests that the commission for placing business in the assigned risk plan be less than the average voluntary market commission. To provide an incentive for consumers to actively seek insurance in the voluntary market, when competition is

restored, the residual market rate should be fixed and established at some modest percent above the average voluntary market rate for each class and territory, or the Commissioner could require ceded drivers to pay a supplement above the ceding company's voluntary market rate. The Attorney General explains that these depopulation incentives would be effective with a risk-sharing residual market mechanism and may not work or could create the wrong incentives with a loss-sharing mechanism. However, if loss sharing is continued, the Attorney General strongly recommends the discontinuation of supplemental expense allowances to servicing carriers for certain ceded policies.

The Attorney General strongly objects to any type of loss recoupment in the restructuring the residual market, as proposed by the AIA and described below. He explains that this would put the residual market on a cost-plus basis and would tend to increase, not decrease the CAR deficit. He also states that the Legislature, in rejecting "rolling reconciliation" when enacting Chapter 273, indicated a strong public policy against retroactive rate recoupment.

Finally, the Attorney General urges that the reform of the residual market mechanism be compatible with competition. The Attorney General advocates flex rating of collision and comprehensive coverages during the 1990 rate year in conjunction with CAR reform.

The AIA Proposal

AIA, a trade organization comprised of 203 companies, writing about 30 percent of the private passenger automobile insurance sold in Massachusetts, also submitted a proposal to implement Section 66. The AIA retained an actuarial consulting firm, Milliman & Robertson, Inc. ("M & R") to assist it in preparing its proposal.

AIA states that rate adequacy is a prerequisite to the success of CAR reform. While AIA advocates the elimination of the fix-and-establish rating law, it notes that a phase-in of competitive rating, beginning with optional coverages, would be an acceptable approach.

AIA also supports the creation of a loss cost adjustment feature if rates continue to be fixed and established by the Commissioner. The loss cost adjustment feature is described by AIA as correcting errors made by the Commissioner in calculating projected loss costs. The loss cost adjustment feature is another version of the rolling reconciliation provision which was rejected by the Legislature during the debate on 1988 automobile insurance reform. To provide an incentive for the industry to depopulate CAR, AIA suggests that the loss cost adjustment feature be phased in and be contingent upon depopulation of CAR.

AIA, like the Attorney General, supports changing the structure of the residual market. In its proposal, AIA notes that CAR currently has many structural similarities to a joint

underwriting association ("JUA") and converting CAR to a JUA would enable it to function more efficiently. The major changes in this conversion would be that each agent would be limited to one servicing carrier; there would be daily transfer of premium received by servicing carriers to the JUA account; claims would be paid from the same JUA account; investment income would accrue to the JUA rather than servicing carriers; and there would be a reduction of transaction costs due to simpler reporting requirements. For the long term, AIA recommends converting CAR to an assigned risk plan. AIA believes that an assigned risk plan would probably work in Massachusetts only if there is a reduction in the size of CAR.

AIA also believes that Rule 11 unfairly allocates the CAR deficit among participating insurers. AIA advocates phasing out the current Rule 11, substituting a formula that determines each company's share of the residual market deficit based on a five-year moving average of each company's voluntary writings. AIA recommends a four-year phase-in of the new rule. AIA's formula incorporates, in the first two years, 1990 and 1991, a "free growth" period which will allow new companies not to participate in the deficit for their first two years and will not penalize companies that write additional voluntary business during the first two years. The AIA formula will penalize companies who reduce their voluntary writings in the first two-year period. AIA believes that its recommended allocation formula is a fair and equitable one.

As a way of discouraging companies from reducing market share or leaving the market, AIA recommends a new reporting rule, which would require a company to inform the Commissioner if it has plans to reduce its voluntary private passenger automobile exposures by 20 percent or by more than 1,000 exposures, whichever is greater. AIA states that it believes that this reporting requirement would give the Commissioner adequate time to respond to company withdrawal plans.

AIA notes that credits are currently awarded to insurers for voluntarily writing undesirable business, e.g., urban risks. AIA states that the current Rule 12 credits, because they are applied to a company's capped participation formula, are not allocated fairly. While AIA did not propose a formal plan for changing the credit formula, AIA states that it believes that credits should be allocated more equitably, and that the credits should be expanded to include more eligible classes and territories.

AIA also notes that CAR reform must stem the growth in the number of ERPs, agents who do not have a voluntary agreement with a CAR servicing carrier. AIA states that because of potential concerns about ERPs' accountability and professionalism, servicing carriers generally cede all policies generated by ERPs to CAR, which increases the number of risks ceded to CAR. AIA believes that growth in the number of ERPs can be slowed by imposing stricter requirements for new agents to obtain a license to sell insurance. The AIA states that

over time, involuntary producers should only be those located in geographic areas with classes of business difficult to place in the voluntary market.

AIA also believes that there are some inefficiencies in the current method of reimbursing servicing carriers for servicing ceded risks. For example, AIA states that because a servicing carrier is reimbursed for the lower of its actual expense ratio and the industry-wide ratio, there is little incentive for companies to reduce expenses. AIA also notes that the additional expense allowance servicing carriers receive for business produced by what are known as Code 03 producers, regardless of whether the business is actually more expensive to service, maintains a meaningless distinction between agents and may cause companies to steer certain business to Code 03 agents in order to obtain the higher expense reimbursement. The AIA recommends that a formula be developed which calculates fees based on each servicing carrier's claim frequency and, to the extent it is feasible to calculate, the number of CAR policy transactions, for example, endorsements, cancellations, changes, etc. AIA believes that this type of formula would create incentives for efficient claims handling, while recognizing that certain classes of business are likely to be more expensive than others to service.

AIA notes that the current CAR rules require companies to handle both private passenger and commercial automobile insurance business in order to qualify as servicing carriers.

AIA believes that servicing carriers should be allowed to handle both private passenger and commercial business, or to choose between them. AIA believes that this would promote efficiency since companies will be handling the business in which they have some expertise.

AIA advocates a number of structural changes to the Governing Committee which, according to AIA, are designed to improve the accountability of the Governing Committee to the system as a whole. AIA advocates increasing the Governing Committee from thirteen members to fifteen members, to be comprised of eight company representatives, six agents, and a new consumer representative. In addition, AIA recommends shortening the current six-year term to two-year staggered terms, with no member serving more than two consecutive terms. The AIA also recommends that the Governing Committee company and agent members be elected by the industry sector they represent, subject to the Commissioner's approval. The consumer representative would be appointed by the Commissioner.

While AIA does not make any immediate recommendations to impose a separate residual market rate or change the commissions to agents for residual market business, it does recommend exploring these reforms after considerable depopulation occurs. AIA states that in three to five years, a separate residual market rate may be desirable because, according to AIA, it would encourage consumers and agents to seek placement in the voluntary market. AIA also notes that

over the long term, if the system develops into one in which the agent plays a meaningful role in the underwriting process, it would be fair to establish a dual commission structure.

Finally, AIA suggests that after depopulation has occurred and a separate involuntary market rate has been established, specialty companies, those companies with experience and expertise in servicing high-risk drivers, should be encouraged to enter the market. AIA states that this will stimulate competition, further depopulate the residual market and facilitate the conversion to an assigned risk plan.

The CAR Proposal

CAR submitted a lengthy proposal containing its recommendations for achieving the Section 66 goals. CAR states that its proposal "reflects the consensus of insurers and insurance producers in the Commonwealth reached after lengthy deliberation." The three principal goals, identified by CAR, and the standards against which CAR judged the potential reform methods it recommends be adopted, are to: 1) reduce CAR's private passenger deficit by 50 percent to approximately 250 million dollars; 2) increase the voluntary market from about 33 percent to 67 percent of the private passenger risks insured in Massachusetts; and 3) enhance the viability and strength of the voluntary agent concept. CAR also notes that future rate adequacy is vital to the success of its recommendations. The CAR proposal states it intentionally does not address methods of reallocating CAR's deficit in a different manner. CAR

states that it believes that reforms to Rule 11 should not be considered until its depopulation, deficit reduction and cost-containment proposals have been implemented and have achieved certain results.

CAR states that, in conjunction with the Commissioner, it also retained Tillinghast, an actuarial consulting firm, in developing models designed to help predict the expected effects of various methods and combinations of methods to reduce CAR's deficit and population. CAR notes that the Tillinghast model is dependent on numerous assumptions. CAR explains that the Tillinghast baseline models are predicated on the following assumptions for the years 1990-1993:

1) total market growth of 3 percent per year;

2) ERP exposure growth of 5 percent per year;

3) an industry average cession rate of 54.3 percent per year excluding ERP business, and approximately 65 percent including ERP business;

4) growth in average premiums per exposure of 7 percent each year; and

5) loss and ALAE ratios at both 80 percent (Baseline 1) and 75 percent (Baseline 2) with expense ratios at present levels.

CAR believes that cession limits and the imposition of cession penalties for exceeding those limits are a necessary part of a depopulation effort. CAR explains that analysis conducted by CAR staff and Tillinghast shows that cession

limits are the most effective method of reducing the CAR deficit as a percentage of voluntary premiums. CAR points out that the Tillinghast analysis shows, under the Baseline 1 model, that cession limits alone can be expected to reduce the CAR deficit as a percentage of voluntary premiums from the projected 73.4 percent in 1993 to 39.8 percent.

CAR recommends that a mandatory cession limit of 55 percent of private passenger voluntary business, exclusive of ERP business, should be established for 1990. For the years 1991 through 1993, CAR proposes cession limit goals of 45 percent, 35 percent and 25 percent, respectively, which will be evaluated during the summer of the preceding year in light of the then-current market conditions. CAR explains that the reason it chose a 1990 mandatory cession limit of 55 percent, even though it approximates the present industry average cession rate, is that some insurers have cession rates considerably higher than 55 percent. CAR assumed that insurers which are now below the industry average cession rate will continue their present cession behavior and therefore, CAR states, the overall cession rate for voluntary ceded business in 1990 may be expected to be measurably less than the current 55 percent industry average.

As the penalty for an insurer's failure to meet the cession limits, CAR recommends denying that insurer its expense reimbursement for the ceded business exceeding the limit, except for taxes and commissions. To deter servicing carriers

from cancelling voluntary agents for the purpose of avoiding cession limit penalties, CAR proposes to establish separate private passenger codes for agents cancelled by servicing carriers after June 30, 1989. CAR states that it will monitor those cancellations and will establish rules to impose appropriate penalties on servicing carriers that use agency cancellation as a means of avoiding cession limit penalties.

CAR explains that it considered adopting objective cession criteria, but it believes that the goals expected to be achieved by establishing cession criteria are already served by cession limits. CAR notes that objective cession criteria are more likely to engender widespread industry dissatisfaction.

CAR recommends that expense allowances for servicing carriers be modified so that they more clearly reflect the actual cost of servicing an individual servicing carrier's ceded book of business. CAR explains that the current expense reimbursement system, whereby servicing carriers receive a higher expense reimbursement allowance for business generated by those agents that were designated brokers under the Facility (Code 03s), does not necessarily correspond with the difference in the actual expense burden of servicing policies from the different types of involuntary agents.

CAR suggests that an interim expense allowance be set each year based on both a maximum total industry expense allowance, as determined by the Governing Committee at the beginning of the year, and a sliding scale method of reimbursement based at

least primarily on claims frequency (on an earned exposure basis) for each servicing carrier's total book of ceded business. The maximum industry expense allowance would be related to the expense needs established by the Commissioner in the annual rate decision. The sliding scale would be based not on the classification of a servicing carrier's producers but instead on those producers' aggregate claim frequency, which is a more reliable measure of the costs of each servicing carrier's particular book of ceded business. This method would be subject to a "truing up" procedure reflecting actual experience during the year in question. Thus, a servicing carrier with a claims frequency on its total book of ceded business which is less than the industry average would have a final expense allowance lower than the industry average by the same proportion. By contrast, a servicing carrier with a claim frequency on its total ceded book of business higher than the industry average would have a final expense allowance higher than the industry average by the same proportion.

CAR contends that the revised method of determining expense allowances will have a number of beneficial effects. Because the ceding expense allowance will be reduced on good business that is ceded, the new method will provide an incentive to depopulate. CAR also notes that it will be fairer to all servicing carriers because it will more accurately reflect the workload placed on each such carrier by its involuntary producers than under the current method. Finally, CAR claims

that the method is simple to implement and will more accurately complement the Commissioner's annual rate decision. CAR estimates that this new method should reduce the current expense allowance by approximately $70 million.

CAR proposes to expand the current credit system to promote greater utilization of credits. The current credits are primarily territorial credits, credits for insurers that voluntarily write risks in certain geographic areas. CAR proposes to institute statistical class credits, to encourage the voluntary writing of certain types of drivers, e.g., inexperienced male principal operators. CAR states that this will decrease the number of risks ceded to CAR and will, in some cases, encourage the voluntary writing of high risks, thereby reducing the CAR deficit as well. CAR notes that according to the Tillinghast Baseline 2 model, the removal of sufficient high-risk loss ratio risks from CAR could reduce CAR's deficit by more than $150 million by 1993 and the CAR deficit as a percentage of voluntary premium by about 10 percentage points.

CAR identifies one of its goals as enhancing the strength and viability of the voluntary agent concept. To that end, CAR proposes to provide to all of its members a listing of involuntary producers, containing information about each producer's volume of business, claim frequency, loss ratios, policy cancellation and other transaction ratios, and assigned servicing carrier and appointment history for the last five

years. CAR expects the distribution of this information will cause insurers to enter into voluntary contracts with some of these producers which would thereby reduce the number of risks ceded to CAR. CAR proposes that when an insurer other than the servicing carrier assigned to an ERP agrees to write some or all of the ERP's business voluntarily, the new insurer will not be permitted to cede that business and the ERP will not be permitted to place involuntary business with that insurer.

CAR also proposes several changes to help reduce the number of new and existing ERPs and to implement and enforce performance standards for new and existing ERPs. First, CAR recommends that its rules be amended to provide certain educational requirements for new ERPs and a requirement that each new prospective ERP work for at least six months with a licensed agent or a Massachusetts automobile insurer, during which time the applicant will devote the majority of his or her efforts to the Massachusetts motor vehicle market. Second, CAR proposes that the Commissioner consider restricting all new ERP appointments, except those resulting from termination of a producer's voluntary contract, subject to the prospective ERP demonstrating "market need," based on criteria to be established by the Commissioner. Third, CAR requests that the Commissioner consider whether any ERP in a market where there is no "market need" for that ERP should be provided with some finite period of time in which to obtain a voluntary contract. Finally, CAR proposes a change in its rules increasing the minimum threshold of writings for ERPs.

CAR proposes a legislative change which would allow for the establishment of a separate CAR rate to be charged to those risks meeting certain specific, objective criteria based on individual driving and claims records. Under CAR's proposal, drivers who meet the "dirty" rate criteria could either be ceded to CAR, with the higher "dirty" premium going to CAR, or retained at the normal rate in the voluntary market. CAR recommends that the separate CAR rate be set by the Commissioner and the objective criteria be determined by CAR.

In conjunction with a two-tier rate structure, CAR recommends a modified commission/expense allowance structure for the "dirty" rate so that there is no incentive for agents or companies to steer business toward the involuntary market. CAR further recommends that if there is a separate CAR rate, producers should receive the same in commission regardless of whether the risk is ceded and the insurer should receive no expense allowance on the surcharged aspect of the premium. CAR notes that this change, to the extent that it excludes commission on the additional premium, also requires legislative change.

CAR states that its depopulation recommendations should help contain CAR's costs. CAR also notes several other recent changes, initiated as a result of the enactment of Chapter 273, which it claims will achieve cost containment. CAR notes that it has proposed an amendment to the CAR rules requiring servicing carriers to implement a direct payment plan involving

body shop referrals which it hopes will result in more competitive repair rates. In response to Sections 41 and 44 of Chapter 273, CAR established claims and SIU performance standards. CAR explains that its Claims Advisory Committee will now consider methods to measure compliance with those standards. CAR notes that it recently began implementing a pilot program in the city of Lawrence involving pre-screening for early detection of fraudulent personal injury claims.

Finally, CAR mentions that it is considering the advisability of requiring servicing carriers to forward premiums to CAR when the policy is ceded to allow reduction of the deficit through investment income.

Comments from interested parties on the AIA and CAR Proposals

The testimony at the May and August hearings held by the Division demonstrated that there is no clear consensus either among the industry or the other players in the market as to how to best achieve the Section 66 goals. There was, however, agreement on some of the proposals. For example, the Attorney General, AIA, CAR, and most of the individuals that presented oral and/or written testimony agreed on the following CAR reforms - adjusting the method of allocating the expense allowance to servicing carriers; expanding class/territorial credits; and expanding voluntary agent opportunities for involuntary producers. Many of the other major proposals generated controversy. At the August hearing, individuals representing companies, consumer groups and agents commented on the AIA and CAR proposals.

Representatives of the following companies: U.S.F. & G, The Travelers, the Hanover Insurance Company, Utica Mutual Insurance Company and CNA Insurance Companies testified generally in support of the AIA proposal. These companies particularly embraced AIA's loss cost adjustment recommendation and AIA's proposal to change Rule 11 to a participation formula based on a five-year moving average. They also strongly supported the proposal to change CAR's structure, operation and administration.

The Attorney General and two consumer groups, MASSPIRG and Massachusetts Citizen Action, voiced strong objections to the AIA's "loss cost adjustment" recommendation as a retroactive rate adjustment which they contend is unfair to consumers and undermines cost-containment objectives.

The agents' organizations, IIAM and PIA, generally testified in support of the CAR proposal. They supported CAR's recommendation not to change Rule 11 until depopulation efforts have been given a chance. The agents also testified that the current Rule 11 has kept the Massachusetts marketplace from absolute collapse. The agents stated that the Rule 11 incentives and disincentives have been effective, and they urged that any change to the formula retain the basic incentives to write additional business and the disincentives to reduce or cease writing business.

The agents also noted what they characterized as shortcomings in the CAR proposal. They stated that cession

caps should be monitored closely to ensure that they do not result in market constriction or agency cancellations as a means to meet the caps. The agent organizations also suggested including some ERP business in the cession caps so as to reduce the pressure that companies may exert on voluntary agents.

All of the individual companies that testified at the August hearing criticized the CAR proposal for failing to address the Rule 11 issue, which they noted has been a major factor in the decision of several insurers to abandon the Massachusetts market. Most of the companies testifying favored some type of rolling average formula.

Arbella Mutual Insurance Company recommended a different approach to allocating the CAR deficit among companies. It proposed a modified utilization formula. Arbella explained the utilization formula as one that is based on the current year and how often a company utilizes the residual market. The utilization formula contains two determinants: the first is based on the current year's voluntary business from voluntary agents and ERPs; and the second is based on voluntary ceded business. A company's share of the deficit is based on a weighted average of the two pieces. The formula excludes ceded business from ERPs because, Arbella stated, there is presently an unequal distribution of ERPs among companies. Therefore, under a utilization formula, companies that use the residual market more extensively receive a disincentive in the form of additional deficit sharing. Arbella also recommended that the

current Rule 11 lower cap be retained in conjunction with the utilization formula.

In a post-hearing submission, AIA responded to some of the questions it had been asked during the August hearing. AIA compared the utilization formula to the AIA's proposed moving average formula. AIA stated that theoretically, both a utilization formula and the AIA moving average formula will result in fair and equitable allocation of any involuntary market underwriting deficit in the long run and that, purely from an allocation perspective, neither one is necessarily better than the other. AIA then notes what it considers to be some theoretical problems with a utilization formula and problems with implementing a utilization formula in Massachusetts.

The Attorney General, AIA and a number of insurance companies criticized CAR's cession limit proposal. The Attorney General criticized the proposed cession caps as especially weak. He stated that because they are exclusive of ERP business, they in effect simply preserve the status quo. A number of companies testified that they view the cession caps as onerous and unfair. They claim the cession limits ignore the fact that not all companies are servicing carriers, that some servicing carriers which write business through independent agents have received a disproportionate share of the business abandoned by the companies that have withdrawn, and that there is an interrelationship between cession limits

and the current Rule 11 incentives and disincentives. Senator John Houston ,on the other hand, testified in favor of establishing strict cession limits.

The Attorney General, MASSPIRG, Massachusetts Citizen Action and Senator Houston also objected to CAR's two-tiered rate proposal. While they believe that surcharges or higher rates for higher risk drivers make sense, they strongly oppose the concept of a higher rate for ceded business simply because it is ceded. They believe that consumers whose policies have been ceded to CAR should be treated no differently than those in the voluntary market. IIAM and PIA also testified that they believe that the higher risks should pay higher rates, but they question CAR's decision to recommend a "dirty" rate within the residual market and not an industry-wide "dirty" rate. They also noted that if the Commissioner approved a "dirty" rate, he should provide that commission dollars remain constant regardless of the nature of the risk. AIA and a number of companies testified in support of the two-tiered rate concept. However, AIA cautioned that a two-tier rate should not be implemented until considerable depopulation has occurred.

There was a difference of opinion as to whether all companies should be required to become servicing carriers with an opportunity to buy out of that status. Some company representatives testified in favor of allowing companies to become servicing carriers for personal lines only or for commercial lines only.

AIA and almost all of the company witnesses recommended that the CAR Governing Committee and subcommittees be more representative of the industry as a whole and that the Governing Committee members serve shorter terms. AIA and some companies suggested that Governing Committee members be nominated and elected by the members, subject to the Commissioner's approval. Some companies recommended restricting Governing Committee members to serving no more than one or two terms. The Attorney General expressed support for AIA's recommendation to add a consumer representative to the CAR Governing Committee. Senator John Houston proposed that the CAR Governing Committee be composed of a majority of public interest members. Some companies advocated removing all agents and brokers from the CAR Governing Committee.

V. TILLINGHAST REPORT AND FINDINGS

The Tillinghast analysis, while exceedingly important, by its nature had to be limited. Creating a mathematical model of individual company behavior was difficult, and it was impossible to project how individual corporate decisionmakers would respond to increased credits and other incentives for depopulation. Accordingly, their analysis was limited to what would happen if companies' cession strategies remained unchanged, despite the major changes in incentives. It is an evaluation of what would happen if the incentives did not work, what could be viewed as a worst case scenario.

Even based on this assumption that companies will ignore changing economic incentives, the Tillighast analysis indicates that the Division's reform package can be expected to reduce the CAR deficit for 1993 alone by approximately $100 million, about one third of the target reduction[6].

Assuming that companies are rational, and will respond to changing incentives by changing their strategies and behavior in Massachusetts, the Division's proposals will produce savings far beyond the model.

A. The Tillinghast Engagement

The actuarial and consulting firm of Tillinghast was engaged jointly by the Division and CAR, at CAR's expense, to provide technical analysis of the various proposals for reforming CAR that have been considered by CAR and the Division. Tillinghast was charged in its engagement, which began in May 1989, with developing and running computer simulation models designed to estimate the possible effects of reform proposals selected by CAR and the Division. Specifically, Tillinghast was asked to analyze and comment on the implications of the proposals for the voluntary and involuntary segments of the Massachusetts private passenger

[6]This number is derived by using the the Commissioner's rate decision loss ratio assumption developed by Tillinghast rather than the alternative, higher loss ratio assumption also used by Tillinghast. If the alternative loss ratio assumption is used, the projected deficit savings would be less.

automobile insurance market. The Division and CAR also requested that Tillinghast analyze the effects of the proposals on individual companies, with the understanding that these results would remain confidential because of their proprietary and competitively sensitive nature. Tillinghast was not asked to, and did not, recommend any particular changes to the residual market system. All such recommendations were provided to Tillinghast by either CAR or the Division, with the knowledge and participation of both. A copy of the Tillinghast report is attached to this report as Appendix A.

B. <u>Key Tillinghast Assumptions and Limitations</u>

To develop its model and reach any conclusions about the future, Tillinghast made a number of important assumptions, which are integral parts of the report and findings. The key assumptions are as follows: (1) CAR provided Tillinghast with all necessary data, and the data are accurate; (2) CAR's estimate of the deficits for policy years 1985, 1986, 1987 and 1988 are reliable; and (3) the Commissioner's Decision on 1989 Automobile Insurance Rates, and the loss ratio implicit in the decision, will produce adequate rates.[7] Tillinghast also notes in its report:

> The various projections in this report are not to be considered Tillinghast estimates of likely future outcomes. The projections are based on the application of economic and

[7]Tillinghast developed an alternative loss ratio assumption using a loss ratio projection 5 percent higher than the figure implicit in the Commissioner's 1989 decision.

> market-related assumptions to the 1987 and 1988 operating results estimated by CAR. The assumptions used are subject to a high degree of uncertainty due to the lack of historical data on which to predict future results and the general inability to model individual companies' reactions to any CAR rule changes that may be implemented. Because of these considerations, the estimates produced in this analysis should be used to show the interrelationships and relative impacts of the various assumptions used and to consider the sensitivity of overall CAR results to changes in those assumptions.

Tillinghast further cautions that the report was prepared for readers with a technical knowledge of the mechanics of the Massachusetts automobile insurance market and that the report must be read in its entirety to minimize the possibility of misinterpretation and/or misunderstanding of the results.

C. <u>The Principal Tillinghast Findings</u>

Using the assumptions outlined above and certain additional, "baseline" assumptions about the future of the Massachusetts automobile insurance market, Tillinghast developed several significant projections and findings. The principal ones are as follows, all of which depend largely on the relative level of rate adequacy:

1. With no changes in the residual market, the CAR private passenger deficit is projected to rise steadily from 1989 through 1993, both in absolute dollars and as a percentage of total voluntary market premiums.

2. Cession limits alone will not significantly reduce, and may actually increase, the size of the CAR deficit,

assuming insurers take out of CAR those risks with loss ratios lower than the current CAR average. However, cession limits are projected to increase significantly the size of the voluntary market, thereby reducing the CAR deficit "load" on private passenger exposures.

3. The entire package of changes proposed by CAR, using a "more likely" set of assumptions, is expected, without any changes in individual companies' cession strategies, to reduce the size of the CAR deficit by 15-20 percent, reaching a projected deficit level of $538-612 million for 1993. Without any changes at all, the deficit for 1993 would be $639-767 million.

4. The Division's package, again assuming no response by the companies to the changed incentives, would be expected to produce similar reductions in the CAR deficit, with one exception. The elimination of CAR's two-tier rate proposal produces approximately a 5 percent greater deficit for 1993 than under the CAR package. However, given the high level of controversy the CAR two-tier rate proposal would engender and the resulting high improbability that it would become law, it is unlikely that the Tillinghast projections, insofar as they include the two-tier rate proposal, will be borne out.

VI. CONCLUSIONS AND COMMISSIONER'S PROPOSALS

The Legislature has, through the process mandated by Section 66, provided us with a unique opportunity to reshape the residual market in a way that will not only further the reform efforts begun in Chapter 273, but also -- and more importantly -- help to stabilize the automobile insurance market for years to come. While the plan discussed below is not the only step that is required, it is an essential one if we are to achieve long-term stability for the first time in almost two decades. It is also important to recognize that the proposals discussed below are parts of an integrated package and are closely interrelated. Any significant change to any one of the proposals is likely to have an impact on other proposals, as with the interplay between CAR credits and Rule 11, and can adversely affect the benefits of the whole plan/package.

The time for making the changes I am proposing is limited. The signs that stability is returning and that confidence is being restored are present, but those sentiments will not last long unless we move quickly to implement this package and to begin taking the other necessary steps to correct the problems in our automobile insurance system.

In evaluating the plan, the Tillinghast projections should also be considered. Based on the Tillinghast assumptions and projections, the Division's package is expected to reduce the CAR deficit for 1993 by approximately $100 million using the

"more likely" set of Tillinghast assumptions. Clearly these savings are significant and must be achieved if we are to stabilize the Massachusetts automobile insurance market. The Tillinghast projections do not account for any change in insurers' CAR strategies in response to these proposals. However, assuming that insurance companies are motivated to increase their profits or returns, and will therefore respond to the strong economic incentives contained in this report, the proposals will reduce the CAR deficit far beyond the Tillinghast model's necessarily simplified projections.

A smaller residual market can mean genuine dollar savings for consumers. The Attorney General and others who have argued that companies should keep the risks that they now are allowed to cede to CAR point out that when a policy is written voluntarily, companies have more of an economic incentive to police losses than when a policy is ceded to CAR, and the losses are shared among the whole industry. The net effect on consumers is hard to quantify, but, for example, in the Attorney General's cost containment filing for the 1988 rates, he measured a potential for cost savings which translated into a figure in excess of $500 million. While I do not necessarily agree with his particular assumptions or methodology, if CAR is depopulated and, as a consequence, even one-third of those asserted cost savings were realized, consumers could benefit by over $150 million per year once the reforms are fully implemented and given effect, as early as 1994.

I have adopted almost all of the CAR proposals with the exception of two-tier rating. While almost everyone agrees that surcharges or higher rates for higher risk drivers makes sense, the concept of a higher rate for ceded business does not make sense and is not fair. I agree with Senator John Houston, the Attorney General, MASSPIRG and Massachusetts Citizen Action that consumers whose policies are ceded to CAR should be treated no differently than those in the voluntary market. Because there are no objective cession criteria, companies can and do cede some good drivers to CAR. These good drivers should not have to pay a higher rate, simply because their policy is ceded.[8]

While I adopted some of the proposals supported by AIA, I must note that I do not support the AIA loss cost adjustment proposal. As was pointed out by the Attorney General, MASSPIRG and Massachusetts Citizen Action, the loss cost adjustment proposal is almost identical to the rolling reconciliation proposal that was rejected by the Legislature last year during the debate on 1988 automobile insurance reform. I cannot adopt a proposal that was strongly rejected by consumers and expressly rejected by the Legislature.

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[8]The Tillinghast report shows, on pp. 6, 12 and 13, that the two-tier rate proposal is estimated to reduce the 1993 deficit by about 5 percent, reduce the deficit as a proportion of voluntary premium by one point, but increase the voluntary loss ratio by one point.

PROPOSALS

1. Revise the structure and governance of CAR

As was noted above, there were several proposals which recommended revisions to the structure and governance of CAR. There is a widespread perception that CAR currently operates as an insiders' political game, dominated by the small domestic companies. This may be as much a perception problem as a substantive issue, but when we are dealing with confidence in the market, perception is a very real issue. While the CAR Governing Committee has worked very hard over the past few years and has done an excellent job under very difficult conditions, I believe it is appropriate and necessary at this time to make changes to its structure to ensure the perception of broader representation and participation of as many divergent interests as possible.

I propose the following legislative changes. I propose that the CAR Governing Committee terms be reduced from six years to four years, to allow for the potential of participation by more companies on the Governing Committee. I also propose adding two consumer representatives to the Governing Committee, thereby expanding the Governing Committee from thirteen to fifteen members. The consumer representatives, to be appointed by the Commissioner, will be required to have expertise relevant to the Massachusetts automobile insurance system, for example, possibly a lawyer, academic, law enforcement person, actuary or accountant, or

even a former insurance company executive or agent with appropriate expertise but an ability to represent the public interest. However, current Governing Committee members should be allowed to serve through the expiration of their current terms.

The other recommended revisions to the Governing Committee can be implemented administratively by amending the CAR Plan and Rules of Operation. I propose that standards for Governing Committee appointments be adopted. For example, in making appointments, the Commissioner should be required to consider the adequacy of representation of as many different interests as possible: foreign/domestic, large/small, direct writer/agency companies, American Agency/exclusive agency, voluntary agent/involuntary agent.

I also propose that policies or standards be developed to ensure the representative character of CAR subcommittees. For example, we will work with CAR to consider the need for technical subcommittees to have the appropriate technical expertise, criteria for selecting or rotating subcommittee chairpersons, problems of overlapping chairpersonships between two or more subcommittees and expanding representation by non-Governing Committee members on subcommittees.

I will work with CAR and other interested parties to develop appropriate standards to be implemented by January 1, 1990.

2. Impose Mandatory Cession Limits for 1990 and Cession Targets for Ensuing Years

One approach to depopulation, and one that was proposed by CAR, is the imposition of cession limits and penalties. A cession cap limits the total percentage of an insurer's business that may be ceded, and therefore directly affects the number of risks ceded to CAR. The Tillinghast models show that the cession limits proposed by CAR are not projected to reduce significantly, and may actually increase, the absolute magnitude of the CAR deficit because it is assumed that insurers will take the best business out of the involuntary market -- that is, profitable business that does not contribute to the deficit. However, the Tillinghast models project that cession limits will significantly increase the size of the voluntary market, and thereby reduce the ratio of the CAR deficit to voluntary market premium, the per policy load that each voluntary policy must carry to pay the deficit.[9]

I recognize that there is considerable industry opposition to the imposition of cession limits, and I too believe that there should be strong economic incentives to depopulate CAR as opposed to penalties imposed on companies for failing to do so. However, I find that the mandatory cession limit of 55 percent of private passenger voluntary business, that is,

[9]Enhanced credits and changes to Rule 11, described below, should actually work to reduce the dollar size of the deficit.

exclusive of ERP business, recommended by CAR for 1990 represents an important signal for change. More importantly, the cession cap is projected to significantly reduce the ratio of the CAR deficit to voluntary market premium and does not impose an unfair burden on the industry. The 55 percent cession limit would only affect the few companies that cede considerably more than the industry average. This limit is not so onerous that it will steer the market away from voluntary agents, cause agency cancellations, or cause companies to leave Massachusetts. In addition, CAR assumed that insurers which are now below the industry average cession rate will continue their current cession strategy. I believe this is a reasonable assumption which should result in an overall cession rate for 1990 which is considerably less than the current 55 percent average rate.

For the years following 1990, I recommend total CAR market share targets or goals, rather than mandatory cession limits. I adopt as targets, a declining market share for CAR, including ERP business, from the current 70 percent, to 60 percent in 1990, 50 percent in 1991, 40 percent in 1992 and 35 percent by the end of 1993. If the industry, as a whole, meets the targets, and individual companies act consistently with those targets, no further cession limits will be imposed. However, if the industry as a whole fails to meet the targets, I, or succeeding Commissioners, will have to consider the need for imposing company-by-company cession limits.

I also adopt CAR's recommendation that the most appropriate penalty for an insurer's failure to meet the initial cession limit would be to deny such insurer its expense reimbursement for the ceded business exceeding the limit, excluding taxes and commissions.

Finally, I concur with CAR that servicing carriers need to be deterred from cancelling voluntary agents for the purpose of avoiding cession limit penalties. I will work with CAR and other interested parties to ensure that there is a mechanism for monitoring voluntary agency cancellations and imposing appropriate penalties on companies that use agency cancellation as a means of avoiding cession limit penalties. I note in this regard that G.L. c. 175, §163 provides some protection against abrupt cancellation by requiring companies to give six months notice of termination, and it provides for a thirteen month run-off, in some cases, after arbitration.

3. Expand Credits for Writing Voluntary Business

There was a consensus among the interested parties that CAR reform should include expansion of the existing system of credits. Credits, together with modification of Rule 11, have the most potential for effectively reducing the dollar amount of the CAR deficit. Currently, credits exist primarily for business written in certain territories, such as urban areas. Presently, credits are underutilized by the industry as a whole, in part because Rule 11 counteracts them in some instances.

One criticism of the current credit methodology is that credits are applied to a company's Rule 11 capped participation ratio. Some companies have complained that for those companies at the lower cap, the value of the ratio of credits to exposures is depressed and that for companies at the upper cap that have a participation ratio greater than zero, the value of the ratio of credits to exposures has the opposite effect. Therefore, lower-capped companies do not receive the same benefit for writing high-risk business as those companies which are between the caps or have exceeded the upper caps. Companies with a small participation ratio, moreover, may reduce their share of the CAR deficit to zero, in which case additional credits would have no value. Therefore, the changes that I am proposing to Rule 11 should give companies a greater incentive to use credits.

In addition, I agree with the CAR proposal to expand the the credits to include statistical classes, such as inexperienced male principal operator risks. This expansion of credits should decrease the number of risks ceded to CAR and should encourage the voluntary writing of risks with higher loss ratios, thereby reducing the CAR deficit.

4. Phase Out Current Rule 11

The most controversial CAR reform issue is when and what revisions should be made to Rule 11, the formula for allocating the CAR deficit among companies. All of the participants except CAR recommended that Rule 11 be changed but the

participants disagreed over the timing and substance of the revision. The CAR proposal and some of the agents' associations advocated no immediate change to Rule 11. Some companies advocated an immediate and dramatic change to Rule 11 -- for example, basing the formula on a company's current voluntary market share starting in 1990. AIA, Arbella and a number of other companies recognize that if Rule 11 is to be changed, there needs to be some transition from the current rule to prevent severe market disruption.

In addition, Section 66 mandates that my proposal address the loss allocation formula. Given Section 66, the importance of the allocation formula, the controversy surrounding the current allocation formula, changing market conditions and the effect Rule 11 has on CAR overpopulation, it would not be appropriate to defer addressing the allocation formula.

The transition and current Rule 11 have served an important and necessary function in maintaining a viable voluntary market over the past five years. The transition and current rule provided incentives for companies to grow and disincentives for companies to withdraw from the market. Rule 11 has prevented destabilizing market fluctuations which may have resulted from companies' responses to annual rate decisions. The current Rule 11 has also prevented companies from abruptly terminating their obligations to the residual market when they have announced their intentions to withdraw. However, the operation of the rule may have inadvertently created an incentive for

companies between their lower and upper caps to cede additional business in order to reach their lower cap instead of attempting to remain level or grow.

Market conditions have changed and are continuing to change and improve. The Commissioner gave substantial rate increases for policy years 1987 and 1988. Last year, the Legislature enacted some significant and long-overdue reforms, and the positive effect of some of these reforms is already apparent. In addition, for the first time ever, the Division is going to conduct the annual hearing to determine whether there should be competition in private passenger automobile insurance early enough in the year to have time to fully address the complex problems with implementing competition. The industry's 1990 rate request of an increase of 13.5 percent is the lowest request by far in four years, and less than half the request of two years ago. Moreover, the decision by the New Hampshire/AIG group not to depart for at least another year to see how the changes we are discussing will work out is evidence that confidence is being restored and stability is returning to the system. With conditions changing so quickly and with the other recommendations to facilitate depopulation of CAR, it is an appropriate time to develop a new loss sharing formula that will further contribute to the improving climate, condition, and confidence level. Failure to revise the allocation formula may defeat our efforts at depopulation, and worse, may result in additional company withdrawals, which could have a devastating impact on the market.

Given that companies have appropriately relied on the current rules in making business decisions over the past few years, any change to the allocation formula cannot be immediate and dramatic. A new rule cannot severely penalize those companies that have responded to the incentives in the current system and greatly reward those companies that failed to respond. A new rule must be implemented in a way that gives companies enough time to adjust and change their business strategies. A new rule must also serve the public interest by promoting a viable voluntary automobile insurance market.

Therefore, I cannot accept a formula in which participation in the CAR deficit is based on a company's current voluntary market share. If participation were based purely on retained voluntary market share, the more of such business that a company writes, the larger the company's share of the involuntary market losses. Conversely, the less voluntary retained business a company writes, the smaller its share of the involuntary market losses. Such a rule would do nothing to encourage business to be written on a voluntary basis and would not discourage companies from ceding large blocks of business in response to temporary market conditions. Such a rule would fail to satisfy the Chapter 175, Section 113H requirement for a fair and equitable allocation formula, one "...based on a method so that no company materially or substantially reduces its percentage of participation by reducing its writings, nor shall any company have their participation materially or

substantially increased because of the action of other companies."

The AIA proposal and the other rolling average proposals recognize the need to preserve some stability in the market. Because they are based on rolling averages over a number of years, they are less subject to market fluctuations than a pure voluntary market formula. The AIA proposal also recognizes the need for a transition period and it proposes that its formula be phased in over four years. However, there are a number of problems with the AIA and other rolling average proposals.

The rolling average formulas are based purely on voluntary market share and do not contain any caps. Under those proposals, companies with greater shares of the voluntary market pay a greater share of the involuntary market losses. This may have the appearance of fairness, but does not encourage companies to increase their share of the voluntary market or provide disincentives for companies drastically reducing their voluntary market share. The promotion of a viable voluntary market is a primary public policy objective of CAR and of CAR depopulation. In addition, the AIA proposal would severely penalize those companies that have responded to the incentives in the current rule and immediately advantage those which have not responded. See Exhibits 24-32 of the Tillinghast report, which contrasts the current Rule 11 to the utilization formula.

In place of the current Rule 11, I am proposing the utilization formula, similar to the one recommended by Arbella, which I believe is a fair and equitable allocation formula. The utilization formula, based on each company's use of the residual market, encourages companies to retain voluntary business. All companies have an equal opportunity to obtain a favorable participation ratio, and the formula is responsive, by allowing companies to respond to changing market conditions. The lower cap will discourage companies from drastically reducing their voluntary market share. The utilization formula therefore retains the important and necessary disincentive for dramatically reducing voluntary business that is contained in the current Rule 11. The utilization formula is fair, effective, simple, should promote stability in the market and is compatible with a return to competition. It should also promote voluntary market growth and is in accordance with Section 113H.

Under the utilization formula that I propose, a company's participation share consists of a weighted average of its voluntary and involuntary market share for the current year. I propose that the formula give 30 percent weight to the voluntary market share and 70 percent weight to the involuntary market share. To allow companies sufficient time to plan and adjust their business strategy, I propose that the utilization formula be phased in over four years. I recommend that effective January 1, 1990, each company's participation share

be based 75 percent on the current Rule 11 and 25 percent on the 30/70 utilization formula. For policy years 1991-1993, the participation formula shall be based on 50 percent current Rule 11, 50 percent 30/70 utilization formula, 25 percent current Rule 11, 75 percent 30/70 utilization formula and 100 percent utilization formula, respectively.

5. Require All Companies to Be Servicing Carriers

The utilization formula will be much simpler and fairer if every company is a servicing carrier. Therefore, it is important to our proposal that every company be a servicing carrier, or be given an option to "buy out" of that obligation.

Under CAR's predecessor, every company was a servicing carrier. At the inception of CAR, it was hoped that limiting the number of servicing carriers would result in a simpler, more efficient system which could more effectively control fraud through establishing servicing carrier SIU's. However, experience has shown that having a limited number of servicing carriers has not necessarily resulted in a simpler or more cost-efficient system and there are a number of benefits to the system of having each company be a servicing carrier. Therefore, I propose that all companies become servicing carriers. All companies will have the option of either "buying out" of the servicing carrier obligation with some payment to CAR representing an approximation of the burden thereby placed on other servicing carriers or of contracting with another carrier to provide the services.

There are benefits to consumers and to the system of having each company be a servicing carrier. If every company writing automobile insurance is a servicing carrier, consumers, including urban drivers, would be able to purchase insurance from more companies. This will enable consumers, if they so desire, to purchase all of the property and casualty insurance they need from one agent and from one company. In addition, if all companies are servicing carriers, the deficit allocation formula can be much simpler and any transition to competition could be more easily accomplished.

A number of participants recommended that companies be allowed to be servicing carriers for private passenger only, commercial only, or both. In implementing this recommendation, I urge CAR to explore whether to allow companies to be servicing carriers for only private passenger or only commercial automobile insurance.

6. <u>Restrict the Growth of ERPs</u>

There was a consensus that CAR reform must stem the dramatic growth of ERPs, those producers who do not have a voluntary agency contract with any company. The amount of business currently handled by ERPs is approximately 23 percent of the market and ERPs represent more than half of all producers. Almost all that business is in CAR.

The concept of an involuntary agent was originally created to ensure universal access to insurance. Historically, companies have not offered voluntary contracts to agents who

serve certain locations, e.g., inner cities, and who serve other high risk insureds. However, due to the turmoil in the automobile insurance market over the past few years, companies have been unwilling to write additional voluntary business, regardless of the nature of the risk. Therefore, there has been tremendous growth in ERP appointments and their volume of business.

One major problem with having so many ERPs is that because there are currently no standards for ERP appointments, most, if not all, of the business written by these producers is automatically ceded by companies even though some of the business written by these producers may be profitable business. This has been a significant factor in the growth of the CAR population. In addition, since the ERP is guaranteed both a market and a commission, there is little incentive for the ERP to develop a voluntary company relationship.

The involuntary agent concept is a very important one which must be retained to ensure that all eligible applicants for automobile insurance have access to insurance throughout the state. Therefore, I adopt CAR's proposal that we determine which ERPs are serving areas of genuine market need. These ERPs will maintain their present status. Current ERPs whose offices are located in areas where there is no market need will have to demonstrate to an appropriate CAR committee that they have been unable to obtain a voluntary contract. If the CAR committee finds that an ERP who is not in a "market need" area,

1) has been offered and has refused a voluntary contract with a company; or 2) has not made a substantial effort to obtain a voluntary contract, that ERP will receive a lower commission structure for three years. If the ERP fails to make arrangements with a company on a voluntary basis by the end of the three years, the ERP will lose his/her ERP status.

I will work with CAR to develop criteria to determine market need and to develop a revised commission structure for some ERPs. I invite the agents' associations to work with CAR and the Division to develop these essential new standards.

In addition, I adopt the CAR recommendations to impose needed restrictions on new ERPs and to implement performance standards for new and existing ERPs. New ERP appointments should be made only on "market need" criteria, as discussed above. I adopt the CAR recommendation that new ERPs also satisfy educational and experience requirements. CAR has suggested appropriate requirements -- successful completion of a course of study approved by the Commissioner, including testing approved by the Commissioner and six months' work experience with a licensed agent or with a Massachusetts automobile insurer, during which time the applicant devoted the majority of his or her efforts to the Massachusetts motor vehicle market. Again, I think the agents' associations can be helpful in developing these standards, as they have been in the past.

Finally, I adopt the performance standards recommended by CAR for new and existing ERPs -- requiring ERPs to write a minimum of 100 risks by the end of their first year and 250 risks by the end of their second, with a one year probation period if those standards are not met.

7. <u>Revise The Expense Allowance Formula for Reimbursing Servicing Carriers</u>

Almost all of the participants in this process recommended that there be a change in the way in which servicing carriers are reimbursed by CAR for servicing their ceded books of business. There was a consensus that the current method, in which servicing carriers receive a significantly greater expense allowance for servicing business generated by 03 code producers than for servicing business generated by other producers, does not necessarily reflect the actual costs of servicing an individual carrier's ceded book of business. I agree that it is more appropriate that servicing carriers receive an expense allowance that more clearly reflects the actual costs of servicing its particular ceded book of business. I therefore adopt the CAR concept of adjusting expense allowances. The method seems to be fair, simple and may result in reducing the deficit by reducing the additional expenses associated with the higher expense allowance level.

The revised expense allowance formula would work as follows. An interim expense allowance would be set each year based on both a maximum total industry expense allowance as

determined by the Governing Committee at the beginning of the year, and a sliding scale method of reimbursement based at least primarily on claim frequency for each servicing carrier's total book of ceded business. The maximum expense allowance would be determined by the expense needs established in the annual rate decision.

The sliding scale would determine each servicing carrier's interim portion of the total expense allowance allocated, excluding commissions, direct selling expenses and premium taxes. A servicing carrier's position on the sliding scale is based on its producers' aggregate claims frequency, an objective relative measure of each servicing carrier's cost of servicing its book of ceded business.

As CAR noted in its expense allowance proposal, this method would then be subject to a "truing up" procedure to reflect the actual experience during the year in question. Specifically, actual claims frequency data would be gathered for each servicing carrier and compared against the ceded industry average. To the extent that a servicing carrier's actual results deviated upward or downward from the average, its ceding expense allowance would be adjusted.

8. <u>Direct Funding of the Automobile Insurance Efforts of the State Rating Bureau</u>

The State Rating Bureau ("SRB") is the analytic and advocacy arm of the Division. By law, 100 percent of the SRB's actual expenses are assessed against the industry and are reimbursed to the Commonwealth.

The SRB plays a critical role in monitoring automobile insurance issues, reviewing policies and setting rates. Adequate staffing of the SRB is in the interest of consumers and the industry alike, and it is critical to successful implementation of these reforms. In fact, the Legislature has specified the staff positions that the SRB should have - lawyers, actuaries, accountants - in order to fullfill its important public purposes.

However, because of the structure of the statute and the appropriation system, these positions are vacant even though, if filled, their costs would be borne by the insurers (I might add, I believe, willingly). We propose instead direct funding of those positions by assessment instead of reimbursement of appropriated funding. This is already done in connection with the Division's Medical Malpractice Unit, and it works very well administratively.

The proposal is revenue neutral from the state's point of view, it would allow staffing of positions that are authorized by statute, and it would enable the SRB to carry out its critical mandate in the area of automobile insurance regulation.

CONCLUSION

With the exception of the proposals to change the composition and terms of the Governing Committee and direct funding of the SRB, Section 66 and G.L. c. 175, §113H(E) expressly authorize me to implement the proposals discussed above administratively, by amending the CAR Plan and Rules of

Operation. I plan to work with CAR and other interested parties over the next three months to develop the specific Plan and Rule amendments necessary for the proposals to take effect on January 1, 1990. I will also hold a public hearing on the proposed Plan and Rule amendments. I believe these proposals can be implemented quickly and without disruption. While I realize that there is not much time for the implementation process, I note that the original CAR Plan and Rules of Operation were approved by the Commissioner on November 1, 1983 and went into effect on the following January 1st.

I am optimistic about the future and I see the process the Legislature mandated in order to revise CAR as presenting us with a unique opportunity, one that may not occur again. The Massachusetts automobile insurance market has gone through crises that have recurred regularly over at least the last fifteen or twenty years, heating up every five years or so, with greater or lesser intensity depending on financial conditions of the companies nationally, the perception of rate adequacy and other factors.

During the last two years, there have been the initial signs that the market is beginning to stabilize. In recent weeks, we had one of the most positive signs of all -- a company group which had already announced its decision to withdraw from Massachusetts formally reconsidered its decision and agreed to stay at least through June 1990 to have sufficient time to assess the impact of various changes we are making, including those contained in this report.

Central to effective CAR reform is the ability of the Division to actively involve itself in CAR issues, market stabilization, policy and rate review and consumer protection. With our other recommendations, therefore, we will be submitting legislation to accomplish direct funding, by the industry, of all the Division's automobile insurance responsibilities, at funding levels no greater than those established for positions which have already been legislatively approved and the costs of which the Division could already assess the industry.

There is much to be done in the coming months to ensure a smooth implementation of the package I am proposing, but with the continuing help and input of everyone concerned I believe we can accomplish tremendous positive changes of lasting benefit both to consumers and to the insurance industry in Massachusetts.